

Bosnia & Herzegovina



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Investment Profile

2001



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Constitutional structure

Bosnia and Herzegovina consists of two Entities: the Federation of Bosnia and Herzegovina (the FBH), and the Republika Srpska (the RS).

At State level: under the Constitution, the state-level government is responsible for:

- foreign policy;
- foreign trade policy;
- customs policy;
- monetary policy;
- finances of the institutions and for international obligations of Bosnia and Herzegovina;
- immigration, refugee and asylum policy and regulation;
- international and inter-Entity criminal law enforcement;
- establishment and operation of common international communications facilities;
- regulation of inter-Entity transportation; and
- air traffic control.

The District of Brcko, whose status was not resolved by the Dayton Peace Accords, has been directly under the State of Bosnia and Herzegovina since 8 March 2000, the proclamation of the District being in accordance with the relevant international arbitration award.

The Bosnia and Herzegovina Parliamentary Assembly consists of two chambers, the House of Peoples (15 delegates, 10 from the FBH, five from the RS) and the House of Representatives (42 members, 28 from the FBH, 14 from the RS). All legislation requires the approval of both chambers.

The Presidency of Bosnia and Herzegovina consists of three members, a Croat and a Bosniak elected from the FBH and a Serb elected from the RS.

The Presidency nominates the Chairman of the Council of Ministers, who is also a Minister in charge of one of the six state-level ministries, and takes office upon the approval of the House of Representatives. The Chairman nominates the six state-level ministers: the Minister of Foreign Affairs, the Minister of Foreign Trade and Economic Relations, the Minister of the Treasury of the Institutions of Bosnia and Herzegovina, the Minister for European Integration, the Minister for Human Rights and Refugees and the Minister of Civil Affairs and Communications, who together with their two Deputies are also approved by the House of Representatives.

At the Entity level: each Entity has a president and a government. The Entity governments are responsible for conducting all affairs not expressly assigned to the State.

- The Federation (FBH) government consists of 16 ministries, based in Sarajevo and Mostar. The FBH's governmental administration is sub-divided into 10 cantons and also municipalities, which are empowered locally to implement various policies and regulations.
- The Republika Srpska (RS) government consists of 19 ministries based in Banja Luka. The RS governmental administration is sub-divided into municipalities.

Introduction



While macroeconomic stabilisation has been achieved and some structural reforms have gradually been made, the pace of reform needs to be accelerated and new legislation implemented in order for the growth of private initiative and the inflow of foreign direct investment to replace the economic support provided by reconstruction assistance. Improved inter-Entity cooperation, now in evidence, needs the support of stronger state-level institutions to ensure that the country can generate income when international support comes to an end.

Recent progress

In approving the extension of its Stand-by credit to Bosnia and Herzegovina, in December 2000 the IMF noted the country's progress towards macroeconomic stability, including low inflation and continued rapid GDP growth (albeit from a low base following the war). It praised country-wide acceptance of the new currency, the konvertibilna marka, which was achieved through fiscal restraint and strict adherence to the currency board rules, and has led to an increase in official reserves. It also praised efforts to implement policies to partially reverse unsustainably high wage and pension increases that had led to fiscal slippages earlier in the year. This was achieved through expenditure control, enhancement of revenue collection and correction of pension imbalances by linking pension entitlements to the level of available resources. However, the IMF emphasised the urgency of continued reform of tax and expenditure to maintain the fiscal balance. The IMF has noted that the budgets for 2001 take the appropriate fiscal stance, with a reduction in military expenditure. Action is also needed to ensure that the level of wage increases remains consistent with the country's competitive position.

Structural reform has also made progress in the past year, but needs to be kept up to create an environment conducive to private sector activity. Major efforts have been made in the financial sector in the past year, notably the reform of the payments bureaux, which have been replaced with a new inter-bank clearing system (see *Financial sector* below). This needs to be followed through by improving financial management. Bank supervision is improving in both Entities. Through the privatisation of state-owned banks, a significant number of foreign investors have entered the banking sector, setting standards and stimulating competition, which will lead to better access to funding for small and medium-sized enterprises (SMEs). However, the restructuring and privatisation of state banks is still a big challenge, and any further delays would hold back the development of the banking sector.

Completion of privatisation over the next two years is a key priority for structural reform. Privatisation of medium and large-scale enterprises by tender, though not advancing rapidly, is

proceeding now that the groundwork for it is finally in place. Efforts are under way to improve the transparency of the tender procedures, which is needed to iron out irregularities in the sales. Small enterprise privatisation is now well advanced.

Labour markets have been undergoing much needed reform, with a complete revision of the labour laws to allow for much greater flexibility in the labour market, which has eliminated an obstacle to large-enterprise privatisation and also to foreign direct investment. However, firm implementation and further reform is needed in order to keep up the impetus. It will also be critical to continue reform of tax and social welfare. High tax rates are encouraging tax evasion and are acting as a disincentive for the establishment of competitive domestic industries. Contribution rates for social security are also high. Both Entities are being encouraged to follow through with plans to reform the tax system by broadening the tax bases, including through greater enforcement, while lowering and rationalising the tax rates, particularly on labour. (See *Investment climate* below.)

Another positive sign for Bosnia and Herzegovina in the past year has been better willingness on the part of ethnically divided government officials to reach a consensus in undertaking politically difficult corrective measures. This has helped urgent reforms to be introduced more rapidly, and gives more positive reasons for hope that they will be properly implemented. There is increasing awareness that the country should and can accelerate its transition to a modern market economy only through creating a single economic space where trade and investment flow freely between the Entities. Stronger state-wide institutions are needed to take responsibility for a greater part of the country's economic and political governance. A more determined effort is also needed to combat widespread corruption more efficiently.

However, alongside the positive gains of the past year, progress in the transition from international reconstruction aid to sustainable development is still limited and there is a long way to go, demanding a continued effort to maintain and accelerate reform and its firm implementation.

Regional Integration

Greater regional integration and improved prospects for cross-border trade and investment, both of which have grown considerably in the past year, are being supported by infrastructure development projects sponsored by the EU-led Stability Pact for South-Eastern Europe. The Pact supports countries of the region including Bosnia and Herzegovina in their efforts to foster peace, democracy, and respect for human rights and economic prosperity. Under the Pact's "Quick Start" package of urgent projects, the country will benefit from upgrading of crucial road and railway transport links and electricity transmission facilities.

At a summit held in Zagreb in November the EU made a commitment to Bosnia and Herzegovina, Croatia, FR Yugoslavia, FYR Macedonia and Albania to help them become potential candidates for EU membership, as long as they are good neighbours, respect international obligations, and work towards

greater economic cooperation and in fighting corruption and crime. In exchange the EU will give about € 4.65 billion to a new aid programme from 2000-06, with more forthcoming if and when the countries should need it as a result of increased regional cooperation.

Apart from increased investment and trade involvement from Croatia and Slovenia (boosted by a new trade agreement with Croatia and the Croatian government that is ready to support the unity of Bosnia and Herzegovina), the change of regime in FR Yugoslavia will open up new trading opportunities, and evidence of increased trade is already apparent. The government of newly-elected President Kostunica was quick to open diplomatic relations with Bosnia and Herzegovina, which will also contribute to the country's political stability. It is hoped that these various new conditions will help Bosnia and Herzegovina to reduce its high trade deficit.



Economic summary



Macroeconomic stability has been maintained and growth boosted by external aid.

However, real GDP is still well below pre-war levels. Economic reform will be the centrepiece of the international community's strategy over the next two years, when the focus will be on accelerating tax reform, enhancing the tax administration system, completing reform of the payments system, strengthening the financial sector and speeding up privatisation.

GDP growth

The Bosnian economy has continued to grow relatively rapidly in 2000 at double-digit rates, reflecting ongoing recovery from the devastating war of 1992-95. Preliminary estimates suggest it was around 10 per cent, somewhat lower than had been predicted earlier in the year; the country's agricultural production was severely affected last year (down by about 15 per cent) by a drought but industrial production rose significantly in both Entities. Growth of 10-15 per cent per year is expected to continue over the next two years. Real GDP, however, is still only about half the pre-war level. The high growth rates of recent years have been sustained by external aid rather than private investment and a continuation of growth requires the pace of structural reform to be accelerated significantly. The 2001 budgets assume real growth of 13.5 per cent in the FBH and 14.5 per cent in the RS.

There is also a significant imbalance between the two Entities, with GDP in the RS estimated at only 75 per cent of the country average. Unemployment is very high, at about 40 per cent of the labour force in both Entities. The main growth areas are services and light industry, with SMEs leading the way. In view of the slow pace of privatisation, they are likely to continue to be the main force for growth in the medium term.

Inflation

Inflation remains subdued, due to both successful management of the currency board arrangement (introduced in August 1997) and relatively tight fiscal policies. However, while inflation remains low in the FBH at around 3 per cent, in the RS it is still in double digits. The budgets for 2001 assume inflation of 4 per cent in the RS and 2.3 per cent in the FBH.

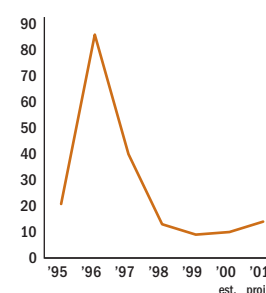
Currency and exchange rate

Following its introduction in 1998, the Konvertibilna Marka (KM) has gained rapid and widespread acceptance throughout the country. The country is now close to monetary unification; the use of other currencies such as the Deutschemark, the Croatian Kuna and the Yugoslav Dinar has greatly declined. From October 1999, all non-cash transactions between the two Entities and within the Federation have been in KM only. New KM1 and KM2 coins were issued in July 2000. The KM is pegged 1:1 to the Deutschemark, which in 2000 fell against the US dollar.

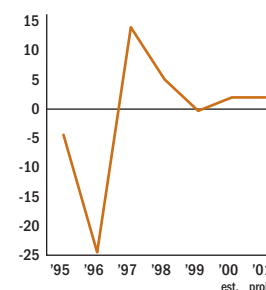
Government balance

Revised budgets for 2000 were passed in both Entities in the second half of the year that managed to preserve macroeconomic stability. Low levels of revenue collection, exports and FDI make the country almost entirely dependent on official aid to cover fiscal and external imbalances. While these will carry recovery through another 2-3 years, the levels of assistance seen up to now are likely to decline sharply over the medium term.

GDP
% change

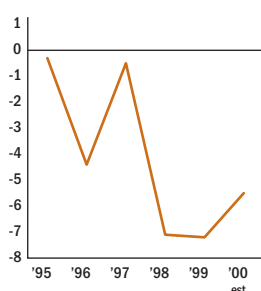


Consumer prices
Annual average, % change
FBH (KM based)*

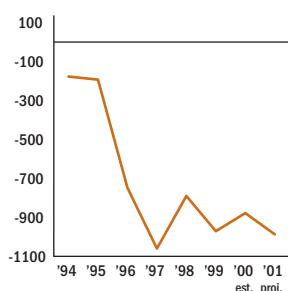


*Before 1995, Retail Price Index (RPI) is used.
From 1995, Consumer Price Index (CPI) is used.

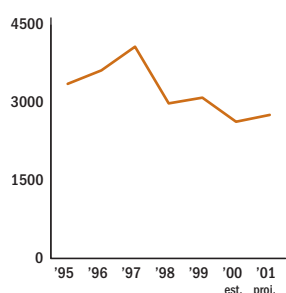
General government balance % of GDP



Current account US\$ millions



External debt stock US\$ millions*



*Excludes capital transfers for reconstruction.

Source: EBRD, January 2001

The tax system remains complex and enforcement is often arbitrary, while military expenditures continue to be a substantial burden on the budget. Tax evasion and smuggling are widespread, and as a result both Entities have faced significant gaps in the budgets, forcing painful cuts in expenditure. The international agencies are putting firm emphasis on the need to reform the tax system to broaden the tax base and lower rates, while lowering expenditure.

The IMF has stated that the overall fiscal stance adopted in the draft 2001 budgets is appropriate. It projects conservative revenue growth of 7.2 per cent in the FBH and 11 per cent in the RS (after adjusting for tax arrears offsets in 2000) and a decline in 2001 of foreign grants and concessional loans. It projects deficit-to-GDP ratios of 1.5 per cent in the FBH and 2.5 per cent in the RS, in line with available foreign financing. If necessary, the budgets will be adjusted at mid-year to maintain the overall fiscal objectives. Military expenditure has been reduced and efforts to reform social welfare spending have begun.

Current account and trade deficit

The external current account deficit excluding official transfers remains large, and the inflows of concessional foreign assistance related to the reconstruction programme continue to be very important in supporting the balance of payments. A sharp increase in the deficit in the third quarter resulted from a widening of the trade deficit in the first half of the year.

In the FBH, the trade deficit for January to November 2000 fell by 22 per cent year-on-year, largely because of a 14 per cent drop in imports. In the RS, the trade deficit for January to November 2000 was equivalent to US\$ 370 million, and also fell compared with the same period a year earlier. A large part of the country's trade gap is linked to reconstruction imports.

External debt

London and Paris Club agreements were reached in 1998, and the external debt/GDP ratio is currently around 70 per cent. Most of the debt is on concessional terms and the debt service ratio is set to fall to 5-6 per cent over the coming years. The main risk related to the external debt is not its level, but the reliance of debt service payments on transfers from the Entities to the State budget. In the medium term there might be a risk of default if declining official international aid is not compensated by a significant increase in private inflows. The State is the obligor for all external debt but has no revenue-raising authority. Debt service is to be transferred "automatically" from the budgets of the Entities (for most debt, two-thirds by the FBH and one-third by the RS). The Entities have had a tendency to delay these payments.

IMF and World Bank agreements

In March 2000 the IMF approved an augmentation (equivalent to about US\$ 22.7 million) and extension (to 31 March 2001) of the country's Stand-by credit, first approved in May 1998 and worth a total of US\$ 122 million. This was the result of the second and third reviews of the Stand-by programme. In December 2000 a further extension was approved to 29 May 2001, following the fourth and fifth reviews, and in view of efforts to revise the 2000 budgets. IMF conditions emphasise the need to improve tax enforcement, especially on high value goods, cut government agency spending and related wage bills, and pass new labour and job placement laws. Some action has been initiated (see *Investment climate* below).

Under its current assistance programme, the World Bank has two credit facilities under implementation, the Second Public Finance Structural Adjustment Credit (PFSAC II, agreed in May 1999) for US\$ 72 million equivalent, and the Enterprise and Bank Privatisation Adjustment Credit (EBPAC) for US\$ 50 million. The PFSAC is aimed at enhancing inter-Entity coordination, priority setting for public spending and improving budget and debt management, and the EBPAC is to support privatisation and banking sector reform. A social sector adjustment operation focused on labour market reform and social protection is under preparation. The World Bank's overall programme has the following objectives: to strengthen institutions and governance, to foster private sector-led growth and develop a social protection strategy to address poverty.

Selected economic indicators								
	1994	1995	1996	1997	1998	1999	2000 est.	2001 proj.
GDP (% change)	na	20.8	86.0	40.0	13.0	9.0	10.0	14.0
Consumer prices (annual average % change)*								
FBH (KM based)	780.0	-4.4	-24.5	14.0	5.1	-0.3	2.0	2.0
RS (DM based)	1,061.0	12.9	16.9	-7.3	2.0	14.0	10.0	4.0
Current account (in US\$ millions)	-177	-193	-748	-1,060	-790	-971	-878	-987
General government balance (% of GDP)	na	-0.3	-4.4	-0.5	-7.1	-7.2	-5.5	na
Trade balance (in US\$ millions)	-803	-930	-1,546	-1,758	-1,959	-1,852	-1,595	-1,608
Total FDI (in US\$ millions, cash receipts, net)	0	0	0	0	100	90	117	164
External debt stock (US\$ millions)**	na	3,361	3,620	4,076	2,985	3,095	2,632	2,763
Unemployment (end year, % of labour force)	na	na	na	37.0	38.0	40.0	na	na
Exchange rate, annual average, KM per DM***	na	100.0	100.0	1.0	1.0	1.0	1.0	1.0
Gross reserves, excluding gold (end-year, US\$ millions)	na	na	235	80	175	455	488	538

* Before 1995, Retail Price Index (RPI) is used. From 1995, Consumer Price Index (CPI) is used.

** Excludes capital transfers for reconstruction.

*** Pre-1997 refers to Bosnian dinar. Since August 1997, Bosnia and Herzegovina has a common central bank.

Source: EBRD, January 2001



Investment climate

While foreign interest is slowly increasing, especially among neighbouring countries, the legal framework for investment is still rudimentary, with most of the legislation in urgent need of redrafting. The business climate in general is still in need of much legislative reform. Privatisation, though proceeding slowly, offers opportunities. The reintegration of the region and international support for it, including more favourable terms of trade with the EU, will contribute to new trade and investment potential.

Foreign direct investment

Foreign direct investment (FDI) is increasing, despite the difficult investment climate. From 1996 to April 1999 1,753 companies involving foreign investment were registered, of which 989 were registered with the minimal equity investment (DM 1,000) and 764 were joint ventures.

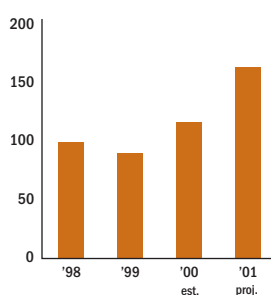
In 2000, net FDI was estimated at US\$ 117 million, up from US\$ 90 million in 1999, reflecting gradual recovery from the after-effects of the Kosovo crisis which deterred investors. However, the level is still fairly low and action is needed to increase inflows of private capital as international assistance decreases.

In 2000, FDI was boosted by investments in the banking sector, notably the acquisition by Raiffeisen Zentralbank (Austria) of Market Banka, and the sale of a majority stake in Universal Banka to Zagrebacka Banka (Croatia). Privatisation in the sector is continuing to attract foreign investors. (See *Financial sector* below.) The entry of foreign strategic investors in the banking sector is expected to provide competitive pressure and thus may improve access to capital and borrowing terms for SMEs, which will benefit the entire business climate.

Inevitably, Bosnia and Herzegovina has difficulty in attracting investment, in view of its recent history, its weak economy and the lack of willingness among officials to make decisions. The legislation and bureaucracy for investment still have much progress to make. Efforts are under way, with the help of the international financial institutions, to improve the investment climate, but it is a slow process. (See *Legal framework for investment* below.)

In spite of these disadvantages, several factors give reason to expect that investor interest in the country will rise. The ongoing privatisation of large-scale enterprises, though proceeding slowly, offers opportunities, and the legal

Total FDI
US\$ millions, cash receipts, net



Source: EBRD, January 2001

background is gradually being improved with e.g. resolution of restitution and ownership issues. With the restoration of regional stability and the major international effort to help the western Balkan region to integrate as a region and also with the rest of Europe, Bosnia and Herzegovina will have more to offer as a base for regional operations and trade.

Another positive sign is the continuing rise in cross-border investments, with Slovenian and Croatian cross-border investments increasing as regional integration improves. For example, among other Croatian companies food processor Agrokor has recently made investments in Bosnia and Herzegovina. Slovenian investments are also rising, with major involvement in tobacco processing, food processing, pharmaceuticals, car parts manufacture, Private Investment Funds, and recently a large shopping centre in Sarajevo. (See *Major sectors of the economy* below.) Trade between the countries of former Yugoslavia is also increasing as traditional links are restored. The opening up of FR Yugoslavia is expected to add to the opportunities.

Legal framework for investment

There is a rudimentary legal framework for foreign investment, under which there is no discrimination against foreign as opposed to domestic investment. The Law on Policy for Foreign Direct Investments (in force since September 1998) regulates FDI and is designed to provide guarantees and legal security for investments. All sectors are open to foreign investors, except that they may not invest more than a total of 49 per cent of capital in arms, railways, air traffic, telecoms or the media. Foreign investors are free to convert hard currency, and all profits can be repatriated or reinvested. The rights of a foreign investor cannot be cancelled or reduced by any subsequent law.

Foreign investors are exempt from customs duty on equipment imported as foreign equity and on raw materials used in export production, when the export value exceeds 30 per cent of the import value. The major forms of business entity that a foreigner can establish are:

- a stock company, established with a minimum of five members, with capital greater than DM 20,000. It must maintain a share registry;

- a company with limited responsibility, requiring two founders and capital of DM 10,000; and
- a company with unlimited responsibility, requiring two or more founders, all of whom are liable for company debts with all their total assets. The founders determine the basic capital.

Formation and registration of a company costs US\$ 100-500 and takes from 1-3 months.

However, in practice the legal system for investment has yet to be developed beyond the inefficient framework inherited from Yugoslavia. It is still difficult for private businesses to flourish amidst burdensome bureaucracy and lack of capital. Inconsistent tax treatment tends to distort competition and tops the list of concerns of businesses in surveys. The legal system varies in the two Entities and is neither consistent nor efficient. The judiciary lacks independence and judgements are not enforced. There is not yet a coherent foreign trade law, and there is no mechanism to challenge expropriation decisions. Corporate governance laws are weak, and management remains effectively in charge in most enterprises. Delays in the privatisation process have limited access to investment finance and given rise to asset stripping (often through creation of “joint ventures” between state and private firms). Property rights, bankruptcy, contract and company laws are all in need of redefinition. The two Entities have separate civil and criminal court systems, based on their respective constitutions. Substantial legislative reforms are urgently needed in all areas of commercial law if a satisfactory business climate is to be created. However, it is a slow and cumbersome process. Legislative initiatives to address these problems have been subject to delay, mainly by the parliaments.

The fight against corruption

The policy reform agenda for investment climate issues and the need to attract foreign capital has become more pressing as the volume of grant aid decreases.

From the start of its involvement, the international community has made a concerted effort to fight corruption, and is now stepping up the emphasis on eliminating corrupt practices and imposing financial discipline. Future support is being linked to progress in these areas, to encourage political leaders to take action. In November 1999 parliament passed an extensive anti-corruption programme proposed by the Office of the High Representative (OHR). It involves creating an independent

judiciary and implementing tighter border controls. This was followed up by seminars to keep the process going. In February 2000 an Anti-Corruption and Transparency Conference was attended by participants from all levels of government, media, civil society, international agencies and NGOs. They unanimously endorsed the strengthening of the rule of law and drew up a detailed action plan. In the wake of the conference Bosnia and Herzegovina signed two Council of Europe conventions on corruption, which oblige signatory countries to introduce legal measures in civil and criminal law that sanction the offence of corruption. This showed a positive step in establishing the political will to take concrete steps to fight fraud and to support transparency and accountability. The OHR is encouraging the adoption of other Council of Europe conventions on money laundering and on bribery as the next move forward.

Political risk insurance facilities

The World Bank and Lloyd's have launched a scheme to encourage investment. It involves doubling the capacity of the Investment Guarantee Agency (IGA) to about DM 100 million. The IGA was established in 1997 by Bosnia and Herzegovina and the World Bank to provide political risk guarantees for investment. By mid-1999 it had issued 22 guarantees totalling US\$ 18.3 million to companies including Siemens (Germany), Ericsson (Sweden) and multinational Scania. Under the new scheme, Lloyd's takes over the task of issuing guarantees from ING Bank (Netherlands). It will allow the IGA to finance US\$ 1-2 billion of trade over the next seven years. There are plans to expand the IGA's services to provide commercial risk guarantees, which would facilitate trade flows and improve the country's access to foreign investment.

In 1997 a partnership between the EU and the Multilateral Investment Guarantee Agency (MIGA, a member of the World Bank) established the Investment Guarantee Trust Fund for Bosnia and Herzegovina, aimed at encouraging FDI by providing eligible investors from the EU with guarantees against major political risks. The Fund totals EUR 10 million and is administered by MIGA. The Fund is designed to facilitate private sector small and medium-sized investments and gives priority to those with a total project cost of US\$ 10 million or less. In November 2000 the first such guarantee was issued to Coca-Cola Beverages (Netherlands). (See *Major sectors of the economy: Agriculture and agribusiness* below.) The second was issued to Volksbank (Austria) to cover investment in the banking sector (see *Financial sector* below).

Free trade zones

There are free trade zones in Sarajevo, Visoko, Travnik, Lukavac, Mostar (two) and Bihac. Foreign investment in the zones benefits from exemptions from taxes and duties (except income tax), simplified customs clearance and permanent customs control and security services. It is estimated that up to 20 per cent of investment costs are saved within the zones.

Foreign Investment Promotion Agency (FIPA)

The Foreign Investment Promotion Agency in Bosnia and Herzegovina exists to encourage and facilitate FDI. It is an independent body designed to create suitable conditions for export-oriented investment and to promote foreign trade.

Its main tasks are identified as:

- promoting Bosnia and Herzegovina as a modern state and as a serious, competitive and reliable partner for investment;
- providing potential foreign investors with information on opportunities and conditions for investment;
- providing consultancy services to local and foreign partners to assist in the preparation of investment projects;
- preparing and conducting foreign investment promotion programmes in Bosnia and Herzegovina and training programmes for local professionals with a view to realising foreign investment projects;
- providing services to local enterprises, in particular SMEs, the Ministry of Foreign Trade and Economic Relations of Bosnia and Herzegovina, and other state and Entity-level institutions in their efforts to establish and renew relations with partners from other countries;
- mediating between potential local and foreign investors;
- making suggestions to the state authorities on the promotion of legislation, and other steps aimed at increasing the inflow of foreign capital; and
- cooperation and realisation of mutual activities with FBH and RS institutions involved in similar activities, and with business associations.

Foreign Investment Promotion Agency (FIPA)

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Privatisation

Privatisation is proceeding, though slowly. The privatisation programmes are intended to repay unpaid government debts to citizens and to distribute state property. Certificates for a nominal value were issued in May 1999 to citizens of the FBH and vouchers to citizens of the RS somewhat later. The total value of vouchers reflects the value of frozen foreign currency savings, unpaid salaries to the military and "general claims" against employment history. Certificates/vouchers can be used as a means of payment in the small-scale privatisation process and in the public offering of shares under the large enterprise privatisation process. Both in small and large-scale privatisation the tender method is used to attract strategic, particularly foreign, investors.

An important milestone in transition was the beginning of **small-scale privatisation** in the FBH in the second half of 1999. Enterprises are being sold either by auction or tender. By May 2000, the Federal Privatisation Agency and the 10 Cantonal Privatisation Agencies had held 813 auctions or tenders, for a total value of KM 218 million (about 2 per cent of the whole country's GDP), two-thirds of which are to be paid in vouchers. Concerns have been raised in a number of cases about the lack of transparency of the process. In the RS, small enterprises are being privatised through a mixture of cash and coupon sales. Vouchers are being issued to citizens based on registration, which started in January 2000. Following a pilot cash auction in July 1999, 53 small enterprises (including large enterprise spin-offs) had been privatised by August 2000.

Large, state-owned enterprises continue to dominate the economy in both Entities and progress in their privatisation has been slow. However, the pace of progress has increased recently, due in part to the activities of the International Advisory Group on Privatisation (IAGP), sponsored by agencies including the EBRD. The IAGP has been instrumental in selecting enterprises for privatisation and ensuring that controlling interests are sold through a transparent tender process. They have tried to avoid privatisation to insiders through management and employee buy-outs.

By August 2000, 40 large enterprises had been sold in tenders in the FBH, and 22 in the RS. In the FBH, about 1,000 large enterprises will be offered in the mass privatisation programme. In addition, the FBH Privatisation Agency and the IAGP have agreed on a list of 86 companies (including telecommunications and power companies, railways and Air Bosnia) in which a majority share is to be privatised by tender,

with minority stakes to be offered to the public. The IAGP has appointed and paid for international experts for the tendering process. Tenders started in September 2000 and the process is expected to last two to three years. In the RS, about 1,000 medium-sized companies are being offered through a mixture of vouchers and commercial sales, the deadline for completion of this phase being March 2001. In the strategic sector, the authorities in the RS are close to agreement with the IAGP on a full list of companies where the IAG will offer assistance, and these will then be offered for tender. The tender process is due to start during the second quarter of 2001.

Enterprise privatisation is expected to take another two years to be fully implemented. However, all major viable companies have to embark on privatisation in 2001 at the latest. This includes the electricity utilities and the telecommunications operators. (See *Major sectors of the economy* below.) Bank privatisation began in 2000 and is now gradually proceeding. (See *Financial sector* below.)

The passage of recent laws and amendments has also helped to speed up privatisation. Most notably, in May 2000, the OHR made an important amendment to the Framework Law on Privatisation of Enterprises and Banks. This measure was designed to overcome two problems. One is the lack of a restitution law at the state level and the second is the often unclear ownership of enterprises and banks scheduled for privatisation. The new amendment ensures that future restitution laws exclude restitution-in-kind of enterprises and banks that have been privatised. If restitution claims and previous ownership rights are upheld, adequate monetary compensation must now be paid to the new owners.

Markets and trade

A programme of trade liberalisation is gradually being implemented, opening up domestic competition. Efforts continue to establish a transparent and non-discriminatory trade regime. During 2001 the levels of specific customs surcharges are to be gradually lowered, with a view to eliminating the customs surcharge over a two-year period. Changes are being made to stimulate exports, such as the removal of a ban on exports of raw timber and its replacement with an export tax.

FBH exports to Switzerland in January to November 2000 rose year-on-year by 84.5 per cent, mostly accounted for by an increase in sales of aluminium and textiles exports. Italy was the second most important destination for FBH exports,

followed by Germany. Cross-border trade with the neighbouring countries is increasing. The normalisation of relations with FR Yugoslavia is expected to contribute to an increase in exports, from the RS as well as from the FBH. FBH exports to FR Yugoslavia in January to November 2000 were more than twice those of the same period a year earlier, and overtook exports to Croatia and Slovenia. FBH exports to Croatia, Slovenia, FR Yugoslavia and FYR Macedonia formed 31 per cent of the total in January to November 2000. The bulk of FBH imports in the first 11 months of 2000 were from Croatia, though they declined sharply compared with the previous year.

A new free trade agreement with Croatia came into force at the start of 2001, under which Croatia immediately rescinded all duties on industrial goods and agricultural produce imported from Bosnia and Herzegovina, while Sarajevo will gradually annul duties on Croatian agricultural products and foodstuffs so that in 2004 it will be covered by a preferential duty of 1 per cent. Under the auspices of the Stability Pact, in January the countries of south-eastern Europe (Bosnia and Herzegovina, Albania, Bulgaria, Croatia, FR Yugoslavia, FYR Macedonia and Romania) agreed to work towards establishing a free-trade area as a preparatory step to EU membership.

In autumn 2000 the EU agreed to alter the General System of Preferences for the western Balkan states, lifting tariffs for 95 per cent of goods, meaning almost entirely duty-free export to the EU. Negotiations are due to start soon with the EU on a Stabilisation and Association Agreement (SAA), designed to result in mutual free trade in 10 years, and free trade in industrial products in the short term. By opening up opportunities for trade with the EU, these moves should contribute to a reduction in the trade deficit.

Exports and imports by region, January-September 2000

Region	Export, US\$m	% of total	Import, US\$m	% of total
Developed countries of which:	261.2	63	708.8	47
EU	173.6	42	592.7	39
EFTA	70.2	17	40.0	3
Other	17.4	4	76.1	5
Developing countries of which:	145.8	35	731.7	48
CEFTA	46.0	11	366.4	24
Other	99.8	24	365.3	24
Unclassified	9.2	2	86.9	7
Total	416.2	100	1,527.4	100

Source: Federal Office of Statistics; NB preliminary data

Reforms relating to social benefits and taxation

The governments of both Entities continue to face substantial difficulties in many areas of social reform. Key priorities are pension reform, labour law reform and tax administration reform and enforcement.

Pension reform is urgent, as the existing system contains large and unsustainable obligations to a number of groups, including war veterans. Efforts are under way to rationalise operations of the pension funds to bring pension entitlements in line with available resources. Measures under consideration in both Entities include a reduction in eligibility for early retirement, the gradual establishment of a closer link between pension benefits and lifetime contributions and the elimination of discretionary pension increases. The month-to-month adjustment of benefits in line with available resources and increased transparency of pension and health fund finances, including independent auditor controls, have been introduced. New legislation was adopted in the RS in late 2000 requiring that pension entitlements beyond a guaranteed minimum be made contingent on the availability of resources, and similar amendments were adopted in the FBH soon after. The World Bank and the IMF have been urging pension reform, and failure to adopt the law held up the disbursement of the fourth tranche of the IMF's Stand-by loan.

Among a package of laws imposed by the OHR in November 2000, a framework has been provided to bring about the merger of the ethnically divided FBH pension funds of Sarajevo and Mostar. Once completed following the relevant audits, the merger is expected to make the pension fund more cost effective and ease labour mobility across the Entity.

Labour laws are another area where the IMF and World Bank have brought pressure for change. The labour laws applying in both Entities reflect in many ways the legacy of the former socialist system, with relatively generous benefits, high payroll taxes, and a large degree of rigidity in recruitment and redundancies. A new labour law passed by the FBH parliament in October 1999 failed to address these problems. In June 2000, the governments of both Entities announced their commitment to revising the laws, with help from the international community, in order to introduce more flexibility in the labour market. These measures, which include the elimination of waiting lists and the reduction of severance costs for those already on them, more flexible provisions on fixed-term contracts and less restrictive provisions on cancelling employment contracts, were approved by the FBH parliament in August 2000 and by the RS parliament in October. Over the medium term, these measures should help to reduce unemployment, currently estimated at around 40 per cent of the labour force.

Taxation reform

Taxation is governed by separate regulations for each Entity and the rates have yet to be fully harmonised between the two. In the FBH the corporate income tax rate is 30 per cent, while in the RS it ranges from 10 to 30 per cent, with higher rates being applied to smaller companies. In the FBH, newly established companies with local and/or foreign shares are exempt from profit tax in the first year of operations, with a 70 per cent exemption in the second year and a 30 per cent exemption in the third. In the RS foreign investors are totally exempt for the first five years.

Some progress has been made in the area of fiscal transparency, and efforts to reform the **sales tax system** have been intensified. Existing sales taxes have been replaced in both Entities with a single-stage, two-rate sales tax that is collected at the retail level. Tax exemptions are being curtailed, the base of the sales tax is being broadened to include construction materials and services, and the exemptions and bases are being harmonised across the two Entities.

In the FBH, steps have been taken to strengthen the **tax and customs administrations** with the start of implementation of an action plan to counteract smuggling. To improve tax collection on high-duty goods, the exchange of information between the tax and customs administrations has been increased, and the number of border crossings at which high-duty goods can enter the country has been reduced. In the RS, measures have been taken to improve the collection of tax arrears and tax on high-duty goods, while the tax on tobacco has been increased. Excise taxes have been included in the sales tax base in order to harmonise them with those in the FBH. The governments of the two Entities agreed in June 1999 that they would harmonise excise taxes both between the two Entities and between domestically produced and imported goods, in order to eliminate distortions to cross-border trade and tax evasion. The final implementation of these measures, however, was delayed until March 2000. Inter-Entity trade appears to be rising (KM 27.6 million of goods traded in the first quarter of 2000, according to official data), although this level is low relative to external trade.

Efforts to streamline the tax administration in both Entities continue, and to enhance tax compliance. The authorities acknowledge that achieving medium-term fiscal sustainability will require further rationalisation of the tax system and a major change in the structure of expenditures, and are continuing their efforts. During 2001, in cooperation with the IMF they plan to implement reform of the system of social contributions in both Entities, to broaden their base and allow a reduction of rates without loss of revenues. Other important reforms in 2001 will cover personal and corporate income taxes. The international agencies are also encouraging the introduction of VAT to replace the sales tax.

Major sectors of the economy



Cross-border activities are increasing, both in trade and investment. Slovenian and Croatian companies are investing increasingly actively. The privatisation programme offers a number of prime opportunities, including the sale of engineering firm Energoinvest as well as energy and telecommunications utilities.

Automotive and machinery

One of Bosnia and Herzegovina's largest industrial conglomerates until the war began was UNIS, which employed about 50,000 people and was active in munitions, car assembly, bicycle manufacture and telecommunications. Of its 84 pre-war companies, 61 survived, but nowadays UNIS officially employs only about 5,000 people. Signs of recovery include a joint venture with Volkswagen (see below).

The Prevent Group (Slovenia) has invested DM 5 million in a new subsidiary, **Prevent Sarajevo**. The new company began operations in January 2000 and produces seat covers for car manufacturers Renault, Peugeot, Volkswagen and BMW. Prevent factories world-wide produce over 11,000 sets of seat covers daily and hold 15 per cent of the European market.

Car component manufacturers include a successful trio based in Tesanj (FBH) – UNICO Filter, Pobjeda (which makes oil pumps) and ENKER (spark plugs). These companies are making significant progress in re-establishing their relations with pre-war clients such as FIAT-IVECO and Volkswagen.

Volkswagen-Sarajevo

Volkswagen was among the largest pre-war investors, but its car plant was in the front lines and suffered badly. However, it has been trying to revive its fortunes with a new joint venture with the same partner as before. At its peak Tvrnica Automobila Sarajevo (TAS) produced about 40,000 cars per year, including Golfs, Beetles, and Caddy pick-ups. Volkswagen's joint venture partner for some 20 years was UNIS Holdings, a leading Yugoslav industrial conglomerate. It imported car kits for local assembly and domestic sales.

Volkswagen has taken advantage of its experience in the country and familiarity with UNIS to get restarted, but in view of the lack of adequate market access and transport systems it has kept its expenditure modest from the start. A new joint venture was established in 1998 in which Volkswagen has 58 per cent control and UNIS the remaining 42 per cent. Volkswagen invested DM 48 million (US\$ 27 million). The joint venture, Volkswagen-Sarajevo (VWS), is located just outside Sarajevo in the customs-free zone of Vogosca where it assembles Skoda Felicias and, since April 1999, Skoda Octavias. Groups of VW's 1,200 Bosnian employees are being sent to the Skoda plant in the Czech Republic for training and work experience.

Unfortunately Volkswagen has not been able to meet its original target of producing some 45,000 cars a year or to fulfil its plans to export to other Balkan countries, the Middle East and North Africa. The factory remains uncompetitive and mainly produces for the small domestic market only. Only some 3,910 cars were produced in 2000, and revised targets aim at some 5,000-6,000 per year. The investment climate has been the main problem, with high taxes, excessive bureaucracy and corruption all interfering. Because the plant only assembles parts imported from elsewhere, it cannot compete with the main Skoda plant in the Czech Republic, which can build cars from scratch at a cheaper price. It is hoped that now that goods made in Bosnia and Herzegovina can enter Croatia free of customs duties, the Skodas made at Vogosca will finally find a market there, though there is strong competition in Croatia from French carmakers Renault and Peugeot. Another potential new market is FR Yugoslavia, now that trade sanctions have been lifted. To help the VWS plant, the authorities have given it tax relief and have established a customs-free zone at Vogosca. Although all the parts for assembly are imported, the cars are treated as a local product, subject to sales tax at 17 per cent, rather than the 40 per cent sales tax on imported cars.

In spite of all, Volkswagen is persisting, and plans to have a full assembly line, using domestic parts, up and running by 2006. UNIS's 42 per cent share in the venture is to be offered for sale through international tender.

Engineering conglomerate **Energoinvest**, which is the country's main producer of electrical power equipment, is to undergo privatisation. At the time of writing (March 2001), the first stage of privatisation was expected to go ahead in the first half of 2001. A 67 per cent stake is to be offered for sale via tender, with 27.7 per cent to go to citizens of Bosnia and Herzegovina in exchange for privatisation vouchers. The company's income in 2000 increased by 10 per cent over 1999, though annual turnover still has a long way to go before it reaches the pre-war level of about US\$ 2.5 billion. Its export revenue increased by 100 per cent in 2000, the main markets being the US, Mexico, Turkey, Malaysia, Algeria and Germany. In January 2001 the company won a US\$ 21 million contract to build transformer stations in northern Iraq under a UN-funded programme, and is expecting to sign another US\$ 30 million contract with Libya.

Agriculture and agribusiness

Bosnia and Herzegovina had 2.5 million hectares of arable land before the war, and produced an annual fruit harvest of about 140,000 tonnes, mainly apples, pears, strawberries, raspberries, plums and peaches, 1.4 million tonnes of cereals, mainly wheat and maize, about 150,000 tonnes of industrial crops, and about 450,000 tonnes of vegetables, mainly potatoes. There was also well-developed livestock farming, including cattle, poultry, sheep and pigs. However, the war had a devastating effect on farming. Much land is no longer cultivated and the flocks and herds were destroyed. Farmers are receiving international aid to rebuild their herds and crops, and much food (e.g wheat) is provided through donations. Fruit and poultry production are being revitalised through new private businesses.

The general economic recovery prompted by international aid is making itself felt in agriculture and the food industry, with increased arable production and food output. The UN Food and Agriculture Organisation has designed a medium-term strategy to modernise agricultural production.

Food processing

Food processing is a sector with potential for expansion. Bosnia and Herzegovina has a high level of food imports, implying that the industry should be able to increase its market share. Obstacles to this include access to technology and willingness to work across Entity boundaries, for instance in establishing supply systems. Some raw food imports attract taxes designed to protect the few domestic producers, but which simply impose higher costs on local food processors.

Case study: Agrokor's cross-border investment in food processing

The EBRD has made a loan of € 170 million to Croatian food company Agrokor to help finance its expansion into Bosnia and Herzegovina, among other activities. The EBRD lent € 70 million on its own account and syndicated the remaining € 100 million to international banks. Agrokor is Croatia's biggest food company, and one of its largest companies operating in any sector. Its key activities involve production of ice cream, mineral water and edible oil and food retail. It has the leading market share in these products in both Croatia and Bosnia and Herzegovina. The EBRD loan is being used to refinance and restructure the company's short-term debt, finance working capital requirements, and to develop its core business, including its recent acquisitions in Bosnia and Herzegovina.

In 2000, Jamnica, Agrokor's mineral water producing subsidiary, acquired Kiseljak, the largest mineral water producer in Bosnia and Herzegovina. Meanwhile Ledo, Agrokor's ice-cream making subsidiary, acquired a Bosnian ice cream producer. The recently acquired Bosnian firms are being modernised with part of the proceeds of the EBRD loan. Agrokor is one of the few foreign investors in the Bosnian food and agriculture sector, and, as one of the strongest player's in the region's food sector, it is already well on the way to achieving its aims for expansion throughout the Balkans. Its activities are contributing to regional integration by giving companies the opportunity to serve larger markets and to be competitive. Reintegration will also contribute to political stability in the region. Furthermore, Agrokor's high standards will have a positive influence on its local business partners, both suppliers and customers, in Croatia and Bosnia and Herzegovina. The project will also help to develop strong regional brands, able to compete with multinational rivals and offering consumer choice.

Perutnina Ptuj (Slovenia) plans to invest KM 30 million (US\$ 13.3 million) to open a poultry processing plant in Bosnia and Herzegovina. Perutnina Ptuj already has a poultry joint venture in the country with Agrokomerc, based in Velika Kladusa, which was once an industrial giant producing a wide range of food products. The joint venture, Perutnina Agrokomerc, is worth KM 13 million (US\$ 6.52 million) and expects to produce some 10,000 tonnes of fresh and frozen poultry each year. Perutnina Ptuj is investing KM 7.2 million to upgrade Agrokomerc's facilities in Bihac.

Coca-Cola Beverages

In November 2000 the Multilateral Investment Guarantee Agency (MIGA) and the EU awarded Coca-Cola Beverages (Netherlands) a guarantee for an investment of US\$ 23.3 million. This is the first such guarantee to be issued through the Investment Guarantee Trust Fund (see *Investment climate* above). The guarantee covers Coca-Cola against the risks of currency transfer restriction, expropriation, and war and civil disturbance. Coca-Cola's investment is in the Sarajevo bottling plant, which it bought in July 1999 for KM 5.5 million (US\$ 2.9 million), when it was the first multinational company to participate in privatisation in Bosnia and Herzegovina. It announced plans to invest about US\$ 23 million in the ruined plant to make it the company's main bottling, logistical and administrative centre for Bosnia and Herzegovina. It has also invested in trucks, cars and coolers, and is installing new production lines for refillable and non-returnable bottles and a waste-

water treatment facility. Following some US\$ 21 million in investment, the company re-opened in October 2000.

Coca-Cola re-entered the Bosnia and Herzegovina market in 1996, using bottling facilities at the Sarajevo Brewery, and by mid-1999 per capita consumption of its products had risen to 71 servings per year. Its efforts to buy the ruined plant were at first postponed by the delays in implementing privatisation, but as soon as the opportunity was available it conducted the very first privatisation transaction. Coca-Cola distributes its products from three sales depots in the main cities of FBH, Bosnia and Herzegovina, Tuzla and Sarajevo, supplying retailers directly by means of its own lorries. For more inaccessible parts of the country it employs local distributors who specialise in beverages. It has a rigorous selection process for its distributors, and unlike most multinationals operating in Bosnia and Herzegovina, it does not demand pre-payment in cash from distributors and retailers. Instead it provides limited credit lines backed by bank guarantee.

Coca-Cola now plans to expand into the RS. This has become easier now that the tax regimes of the two Entities are gradually being normalised. It plans to use the same sales and distribution techniques as in FBH, by establishing a branch office and sales depot within the RS and employing independent distributors. To counteract smuggling of its products into Bosnia and Herzegovina from Hungary, it will launch promotional campaigns including contests which only customers of the locally produced drinks can win. Counterfeiting is also a problem in the RS, but Coca-Cola hopes that the availability of its products in the RS will show consumers the difference in quality between fakes and the real thing.

Breweries

Brewing has been one of the first manufacturing sectors to be privatised. In October 1999 Interbrew (Belgium), one of the five biggest brewers in the world, acquired a 51 per cent stake in the Grude-based Uniline brewery. Uniline's new brewery, with an annual capacity of 300,000 hectolitres of Ozusko lager, opened soon after. It also distributes imported Stella Artois beer, Interbrew's key brand. Interbrew has also bought stakes in breweries in Ukraine, Romania and Russia.

In June 2000 the **Tuzla Brewery** (Pivara Tuzla), one of the oldest and leading breweries in the country, signed an agreement with the EBRD for a convertible loan of DM 12 million in. The loan, to be paid in two tranches of DM 8 million and DM 4 million, is part of a total investment of DM 24 million (€ 13 million) to enable the company to modernise and upgrade its brewhouse to improve production quality and efficiency. The investment has the demonstration effect of showing that a

majority privately owned company with solid management and good corporate governance can attract long-term financing. The loan will finance a modernisation programme that began before the war in 1991, and will allow the company to improve production quality and efficiency. The brewery produces its own brand of beer, carbonated soft drinks and mineral water for the local market at facilities in the centre of Tuzla. Beer represents about 90 per cent of sales. The company plans to expand its sales across the FBH and into the RS. As well as upgrading the facilities to improve quality, this will require development of its marketing and distribution activities. The company has been successful in recovering its pre-war production and market position.

In 1997 the EBRD lent DM 8 million to the **Sarajevo Brewery** to develop its sales of soft drinks. With a parallel loan from the IFC, the Sarajevo Brewery has successfully upgraded its production facilities and the quality of its products. The company was privatised before the 1992-95 war and is now majority owned by management/employees. In January 2001 the Slovenian brewery and soft-drinks company Union acquired a 12 per cent stake in Sarajevo Brewery. The companies are currently developing a strategic partnership.

Tobacco

In November 2000 Slovenia's Tobacna Ljubljana signed a long-term cooperation agreement with the Banja Luka tobacco factory, under the terms of which the factory will benefit from equipment worth DM 5.9 million. The value of planned annual production of licensed cigarettes is to be DM 25 million. Ljubljana Tobacna is on a par with leading European tobacco firms in terms of quality and technical know-how, and can also help the Banja Luka factory to expand its export markets. Meanwhile, a Japanese/Italian tobacco concern has expressed interest in buying a 60 per cent stake in the Mostar tobacco company.

Construction materials

Bosnia and Herzegovina has 22 construction material manufacturers, of which the largest are Kakanj and Lukavac cement plants.

In November 1999 a privatisation plan was agreed for a 51 per cent stake in the **Kakanj cement plant**, located in Zenica-Doboï canton (FBH). Following an international tender, in March 2000 the winning purchaser was Heidelberger Zement (Germany), which paid KM 55 million (US\$ 27.2 million). Heidelberger Zement is to invest KM 90 million over the next 10 years. A 13.5 per cent stake was sold to employees before the war.

The remaining stake will be offered for sale in exchange for privatisation vouchers. The plant produced 350,000 tonnes of cement in 1999, though its full capacity is 550,000 tonnes. It covers 35 per cent of the country's cement consumption and produces composite cements. This was Bosnia and Herzegovina's first large company to be privatised. The Lukavac plant, which has a capacity of 350,000 tonnes, is due to be privatised shortly.

In November 2000 the EBRD made a loan of € 20 million to Croatian cement maker Nasicecement to help it to become more cost-effective and to provide financing for potential acquisitions in related businesses in the region. Nasicecement already exports cement to Bosnia and Herzegovina, and aims to increase its market share through acquisition of a local cement factory.

Chemicals and pharmaceuticals

Before the war, Bosnia and Herzegovina had a thriving chemicals and pharmaceuticals sector, producing sodium carbonate, sodium hydroxide, aluminium sulphate, liquid chlorine, soap and detergents, ammonium nitrate, acetone, and acetic acid, among other products. The largest companies, all still in operation, are Azot (in Gorazde), Boris Kidric Coking and Chemical (in Lukavac), Bosnalijek (in Sarajevo), Elektrobosna (in Jajce) and SODASO (in Tuzla). Gradually, they are building up their business to former levels. SODASO has invested in new technology and is renewing its trading links. The holding has its own salt mines and its companies produce, among other items, edible salt, soda ash, detergent (at the DITA plant) and polyurethane. Polihem, one of SODASO's plants, restarted operations in mid-1998, re-employing 700 people and quickly concluding export contracts worth DM 6.5 million.

Bosnalijek, based in Sarajevo and established in 1941, is the only industrial producer of drugs in Bosnia and Herzegovina. In 1997-99, the company rapidly conducted a major rehabilitation programme. It has introduced a range of new pharmaceuticals and developed its marketing activities, as well as re-establishing cooperative agreements with foreign partners such as Novartis (Switzerland), Pharco (Egypt), API and JPM (both Jordan). It is now working on a development programme to produce over 100 new pharmaceutical items. All its products are designed to meet high international quality standards. In September 1998 it opened a new production plant for solid oral drugs, equipped with the latest technology, in cooperation with Slovenian pharmaceuticals maker Lek, which

invested US\$ 1.5 million. Other investors in the new plant included Japan, Saudi Arabia, and the Islamic Bank. In January 2001 the IFC announced its intention to convert a US\$ 2.7 million loan to Bosnalijek into equity, and will take a 13 per cent stake in the firm. The IFC loan is financing 40 per cent of a US\$ 5.9 million modernisation programme for the company's solid oral drugs plant. The investment will also pay for the installation of tablet coating and packaging equipment. Slovenia's construction firm IMK Klima Montaza has won an international tender to implement the modernisation.

Retail

A new shopping centre, **Trade Center Mercator**, opened in Sarajevo on 1 December 2000, established by major Slovenian trade concern Business System Mercator, which has invested KM 48 million (US\$ 21.5 million) in construction. The Trade Center Mercator (aka Mercator Centar Sarajevo) employs some 350 people and occupies 27,000 square metres, including a hypermarket as the main store, with the remaining 20-25 business spaces rented to banks, restaurants, jewellery shops and other stores. The centre also has a free car park. The supermarket sells 30,000 different products, mainly from Bosnia and Herzegovina (40 per cent of all goods) and Slovenia, but also from other European sources. Mercator operates in Bosnia and Herzegovina as a joint venture, with the Slovenian company holding 51 per cent and the state-owned Trzni centre holding 49 per cent. Mercator has also financed the reconstruction of a railway track for cargo from Sarajevo railway station to the new Trade Center. Mercator is to open a similar shopping centre in Pula, Croatia.

In November 2000 the 15,000-square metre Klas centre opened in Sarajevo, comprising a supermarket, a discount warehouse, a café, a garage for 130 cars and parking space for another 150. MacDonald's (US) is due to open two restaurants in Sarajevo in mid-2001, employing up to 120 people, leasing the premises rent-free for 20 years under a contract agreed with the local municipality. McDonald's will source its supplies from local producers who will be required to meet its quality standards.

Mining and metallurgy

Coal

Reserves of coal are estimated at 3.8 billion tonnes, of which over 60 per cent is lignite. Coal production centres on Tuzla and Zenica (in the FBH), and Ugljevik and Gacko (in RS). The country has over 30 coal mines. Brown coal reserves are mined in five

coal basins, Banovici, Kamengrad, Middle Bosnia, Mostar and Ugljevik. Following modernisation of mining in the late 1970s, by 1991 annual production was 18 million tonnes, of which just over half was brown coal, and the rest lignite. More than half the lignite reserves are in the Kreka basin, while large reserves are also contained in the Gacko and Stanari basins.

Annual production in the FBH area had reached an estimated 12 million tonnes by 1990, but it dropped greatly during the war. In 1999 it totalled 3.9 million tonnes, less than in 1998 as the conflict in Kosovo reduced demand. Two main companies now run the coal mines in the FBH, Middle Bosnia Coal Mines and Tuzla Coal Mines. More than 80 per cent of their output is used to power the Kakanj and Tuzla power stations. Coal production in the RS has been slowly recovering since the war. The largest mines, near Ugljevik and Gacko also supply local thermal power plants. (See *Energy* on page 20.) The Gracanica mine at Gorni Vakuf in the FBH is ready to be privatised, and has negotiated with potential buyers from Turkey and Hungary.

Coal mining faces the painful process of major restructuring. Although traditionally domestic coal has fuelled much of the country's power supply, the decline of industry has reduced the energy demand, and thus the demand for coal. Coal mining also suffers from over-manning, with several thousand workers temporarily laid off on reduced pay. Local production costs are higher than the cost of imported coal, and the industry works at a loss. A study sponsored by USAID aims to identify ways to reduce costs and make the sector economic.

Iron and steel

Bosnia and Herzegovina also has rich deposits of iron ore, estimated at about 750 million tonnes, in the regions of Jablanica, Ljubija (near Prijedor), Mount Radovan and Vares. There is a steelworks at Zenica, which formerly had an annual capacity of 1.85 million tonnes of steel, but which now produces around 100,000 tonnes per year, importing billets from neighbouring countries. A joint venture (BH Steel Company, see box) exists with the Kuwaiti Investment Authority (KIA), which has provided working capital and investment. The joint venture only involves the steel production facilities at the Zenica steelworks. The rest of Zenica's facilities are separate and perform various other services (such as concrete block production and hotel and restaurant services). Zenica still needs major restructuring to become competitive and attractive for investors. An estimated US\$ 30 million is needed for modernisation and new technology. There were formerly eight

other finished steel production facilities, making products such as rolled steel and wire. Activity is now at a standstill, but there is potential to restructure and reactivate these enterprises.

BH Steel Company

Announced in January 1999, the 50:50 joint venture between the Kuwaiti Investment Agency (KIA) and the Zenica steelworks is called BH Steel Company. The two partners have each invested US\$ 90 million in the venture, with a further US\$ 45 million for modernisation provided through credit and by raising the company's capital. The upgraded works is expected to have a capacity of 1-1.4 million tonnes per year when complete, and will be used primarily for the production of reinforced steel bars for the construction industry. Once the entire project is complete, BH Steel's product range will include reinforcing bar as well as traditional Zenica products, such as sections and wire. BH Steel is considering expanding its project to become an integrated steel mill again. The company is looking for a strategic investor to join KIA and the local company in this endeavour. Negotiations have been held with Germany's Thyssen-Krupp, among others. However, the venture has not been trouble free. The company is said to lack a market for its steel and to need restructuring including a reduction in the workforce.

Aluminium

Another valuable resource is **bauxite**, with estimated reserves of 41 million tonnes of ore found in three main regions, the southern part of the FBH (Mostar and southwards), the eastern part of RS (Zvornik and Vlasenica), and the north-west of the entire country (between Bosanska Krupa and Banja Luka). The ore contains about 50 per cent aluminium oxide and about 5 per cent silicon oxide. Further reserves have been identified but not graded for quality.

Aluminij Mostar

To process the country's bauxite, aluminium plants exist in Mostar and Zvornik, near the main reserves. The Mostar site, Aluminij Mostar, benefited from the design and engineering assistance of Aluminium Pechiney (France) to build an alumina plant with an annual capacity of 275,000 tonnes of hydrated alumina, most of which was processed into metallurgical grade alumina. An aluminium smelter was built in the late 1970s to produce primary aluminium and alloy, and went into operation in 1981 with an installed capacity of 92,000 tonnes. There is an automated anode production facility with a capacity of 100,000 tonnes of green anodes and 58,000 tonnes

of baked anodes per year, most of which is exported to Europe. Most of the smelter's aluminium products are exported (via the port of Ploce) to Switzerland, France, Germany, Italy, the US and Croatia. Major customers for ingots were Daimler Benz and Fiat. The plant achieved record output in 2000, producing more than 100,000 tonnes of metal, over its target of 93,000 and up from 70,000 in 1999 and only 28,000 in 1998. It also achieved its aim of recovering pre-war export levels, and recorded exports worth almost US\$ 150 million. It accounts for one quarter of all the FBH's exports. In July 2000 the plant signed a credit deal with German bank WestLB for DM 100 million, which this year it is using for a major modernisation programme. It has also signed a nine-year consultancy contract with Germany's VAW Aluminium AG, a unit of Viag AG. Total planned investment in 2001 will amount to DM 140 million, to modernise the smelter, the foundry and the anode unit. Once the modernisation is complete, annual output is expected to increase by 20,000 tonnes of metal, and exports in 2001 are expected to have a value of about US\$ 143 million. Exports from the Mostar plant account for more than half of the transit activities of Ploce port.

The Zvornik-based plant, Birac, produced 600,000 tonnes annually of alumina before the war, which has fallen to 300,000 tonnes. Birac has had problems paying its energy bills and relies on government-backed bank credits, lately from Balkan Investment Banka, which represents the interests of Lithuania's Ukio Banka and Ukio Investment Agency in the RS. However, Birac is important to the RS economy and a large exporter, and is going to be privatised soon (bids have already been submitted to the RS Privatisation Directorate).

Oil and gas

Bosnia and Herzegovina has no reserves of oil or gas and is dependent on imports. However, it has a history of oil processing. The oil refinery at Bosanski Brod (RS) used to produce petrol, oil, fuel oil, bitumen, greasing fuels and gases to a capacity of 5 million tonnes per year. The products were sold within former Yugoslavia. However, the refinery was damaged during the war. With assistance from the RS government and a US\$ 1.5 million grant from Japan it has now successfully restarted production and a number of foreign companies have shown interest in investing in the refinery. The US government recently provided a grant for a study on the modernisation of the refinery.

There is another small refinery for lubricants at Modrica, capable of producing mainly motor oil, industrial oils, lubricants and various motor fluids. Production facilities at Modrica did not

suffer badly during the war, and the refinery now has a recovery plan involving refurbishment of the packing line and laboratory facilities. Its products meet EC standards and are sold to former Yugoslavia and other countries.

Natural gas is imported from Russia by pipeline via Belgrade, to Zvornik and Sarajevo. Imports total about 320 million cubic metres per year. There is a plan to extend the pipeline from Zvornik into the western part of RS, through Bijeljina, Brcko and Derventa to Banja Luka and Prijedor. The price of gas is pushed up by transit costs. UK consultancy NERA is engaged in the reconstruction of the Bosnia and Herzegovina gas supply and has been investigating ways of lowering the costs.

Forestry, wood processing and furniture

Bosnia and Herzegovina has almost 300 million cubic metres of forest, of which about a third is deciduous (mainly beech and oak) and the rest coniferous. In the days of Federal Yugoslavia, this area produced about 30 per cent of the entire country's timber reserves, and exported large quantities of timber to other Yugoslav republics such as Croatia and Slovenia, where it was processed. Large-scale wood processing was also carried out in Bosnia and Herzegovina itself.

The sector faces some obstacles to recovery of its former output levels and export markets. Almost a fifth of Bosnia and Herzegovina's forests have been left inaccessible due to mines, which have yet to be cleared. A lot of timber still contains shell and bullet fragments, which lowers its quality and adds costs to processing.

The lumber sector now consists mainly of logging and sawmills that produce a limited range of goods, such as boxes and pallets. There is a lack of modern machinery and new designs for more sophisticated, value-added wood processing. However, furniture making is a thriving sector with good prospects, according to a USAID study, as long as it can raise quality and productivity, and, most importantly, improve design. In 1998 the IFC, which usually only lends to private sector companies, provided a DM 25 million agency line to half a dozen furniture makers in both Entities, on the understanding that they will be privatised by the end of 2001.

Under the 1998 EU-Phare programme, up to € 8 million is being contributed to projects in the forestry sector, in support of a € 18.5 million World Bank programme. The projects include support for forest management (including technical assistance for policy reforms), protection and rehabilitation of forests, and rehabilitation of state forestry enterprises and their infrastructure.

Six strategic companies in the RS wood industry are being privatised through a tender announced in January 2001.

Infrastructure

Bosnia and Herzegovina was initially confronted with the need for large emergency investments in order to rehabilitate war-damaged infrastructure. This initial phase is largely complete with significant investments made in transport, telecommunications and the power sector. The efficiency of infrastructure services has suffered from separation along ethnic lines, although some progress has been made with inter-Entity infrastructure links. The international community anticipated the need to eventually provide reform in this area by establishing a Commission on Public Corporations. They have recently adopted a strategy to drive more rapid progress in establishing state-wide institutions and have selected telecommunications and electrical power as areas on which to focus. These sectors are to be privatised through tenders involving strategic investors.

Besides integration within the country, efforts are also being concentrated on links with the south-eastern European countries and the wider European region as well.

Telecommunications

Efforts are now under way to introduce privatisation and competition to the telecoms sector, which runs along ethnically divided lines, with three companies operating in ethnically defined areas. A new Telecommunications Sector Policy has been adopted by the Council of Ministers (at State level). In March 2001 the OHR merged the Telecommunications Regulatory Agency and the International Media Commission into a single communications regulator (the Communications Regulatory Agency).

Before the war Bosnia and Herzegovina had a relatively modern telecommunications network with a high degree of digitalisation. There were about 750,000 subscribers, representing about 15.5 lines per 100 inhabitants. The monopoly operator was the Post, Telegraph and Telephone (PTT) company, a branch of the Federal Yugoslav PTT. There were 6,000 international lines including 700 direct links with former Yugoslav countries. Most international calls were routed through Belgrade or Zagreb.

War damage, estimated at US\$ 222 million, destroyed a large part of the network. Apart from the cost of repairing the damage, an additional estimated US\$ 132 million is required to expand and modernise the system. Under the reconstruction

programme, the EBRD was given the responsibility for coordinating assistance to reconstruct and modernise the telecoms system. Based on a medium-term development plan, the EBRD helped to draft new legislation and set up a dialogue within the Entities on a new, liberalised sector policy. The Telecom Emergency Reconstruction Project (TERP), being implemented and partly funded by the EBRD (along with bilateral donors), provides the framework for a country-wide reconstruction programme.

In the short term, the plan was to restore telephone services, install new lines, increase investment capacity of the operators by increasing revenues through improved billing systems and collection rates, rebalance tariffs, and increase the number of lines. Significant demand was expected from former subscribers who lost lines because of the war, returning refugees, growing business activities and international organisations. Medium-term development aimed at restoration of the network to its pre-war capacity, with expansion to 800,000 lines by 2000, as well as modernisation of the long-distance network and international communications. By the year 2007, the number of phone lines per 100 inhabitants is expected to reach 30, assuming installation of 694,000 new lines and replacement of 241,000 lines financed by operators' internally generated funds. This would require an investment of US\$ 877 million. Privatisation has been identified as the only way to attract the necessary investment.

Ultimately, **privatisation** and sector deregulation are expected to provide the engines of growth by allowing private capital to contribute. In November 2000 a new liberalising telecoms policy was adopted (and published in the Official Gazette in March 2001) by the state government including plans for the eventual privatisation of all three PTTs, which is due to go ahead in 2001.

Under the privatisation plan for PTT Bosnia and Herzegovina, a majority stake of the company is to be offered through tender. PTT Bosnia and Herzegovina is the largest of three telecoms operators in Bosnia and Herzegovina (409,000 fixed line subscribers), and from its base in Sarajevo runs both fixed and mobile networks mainly in the Moslem areas of the FBH. It serves about 1.5 million people and has an international gateway offering land and satellite-based international access. It operates a GSM system with about 110,000 subscribers. Restructuring is under way, with the separation of the Post and Telecoms divisions expected to take place shortly.

HPT Mostar, based in Mostar, is a joint venture with Croatian Posts and Telekom (HPT Zagreb). HPT Mostar serves about 700,000 people (110,000 fixed line subscribers) and has its own international gateway. Completion of the separation of the Post and Telecoms divisions is also expected shortly. Telekom Srpske, based in Banja Luka, serves about 1 million people and has 266,000 fixed line subscribers. It also operates a GSM network with some 75,000 subscribers. International calls are routed via its own gateway.

New telecommunications law

In September 1998 a new telecommunications law regulating international and inter-Entity traffic was imposed by the OHR and later adopted by Parliament. It establishes a Telecommunications Regulatory Agency, charged with setting terms and conditions for international operator licenses and for the use of frequencies required for inter-Entity and international services, defining standards for interoperability and issuing regulations "with regard to Common Facilities". The law also provides for the establishment of a Telecommunications Advisory Group and a Radio Frequency Consultative Committee. The two Entities must still produce their own laws for regulating internal telecom traffic. Draft Entity-level telecoms laws and tariff policies have been developed by the EBRD in cooperation with the ITU, and their adoption by the Council of Ministers was awaited at the end of 2000. The two Entities have agreed that they need to create a common company to carry out maintenance of the country's weak television and radio transmission infrastructure.

Mobile telephony

PTT Bosnia and Herzegovina's mobile operator is called BiH GSM. Its GSM signal covers about 35 per cent of the FBH, serving about 110,000 subscribers. A GSM system called Eronet is operated in Mostar and in the southern Herzegovina region by a private operator (a joint venture of local and Croatian investors). In August 1999 Telecom Srpske launched the RS's first GSM network, the third in the country after GSM BiH and Eronet. Named Mobilna Srpske, initially it covered Banja Luka and three other cities in the north-west. Mobilna Srpske currently has 75,000 subscribers.

A plan initiated by the OHR to offer the three ethnically defined telephone companies mobile phone licences for the whole country is designed to introduce competition and force out operations that run strictly upon ethnic lines. GSM licences for the whole country will be offered by the newly created Communications Regulatory Agency.

Reconstruction and expansion of the telecommunications system has been under way for the past **four** years, but the PTTs have conducted separate development programmes. Bilateral assistance has funded most of the work to replace equipment and provide new exchanges, besides which each operator has its own self-financed priority projects. Much has been achieved, with over 100,000 subscribers connected, exchange centres operational, new switching capacity and two GSM networks installed, transmission networks between the main cities and international links restored.

For the time being the three fixed line operators do not compete with one another and enjoy monopolies in their set areas. The new telecommunications law introduced in September 1998 (see box) obliged each operator to apply for an operator licence with the state Telecommunications Regulatory Agency, and then with the respective Entity authority. It also gave the opportunity for competition and creation of new companies, but its implementation is blocked for lack of additional legislation. Administration of common and international telecommunications facilities is the responsibility of the Bosnia and Herzegovina State government, while within each Entity the respective ministries of Transport and Communications see to all other activities relating to regulation and development projects.

Capitol Communications Corporation and U-UNET (both US) have a contract with PTT Bosnia and Herzegovina to provide the infrastructure for **Internet services**. AT&T (US) is working with a local company, EKIS, to provide Internet services to business users throughout the country. Another Internet service company, FNet Corp (part of Franklin Telecom), has bought and is operating an 11-site satellite telephone network used by NATO troops when they were stationed in Bosnia. The network, originally set up for soldiers to call home, now produces revenue of over US\$ 100,000 per month, serving local enterprises as well as the offices of international agencies. Fnet's operating partner is technology specialist Megaburst Inc (US). Also present is Austria's EuroproNET, which is establishing a Balkan-wide ISP network.

Energy

Bosnia and Herzegovina's total installed power generation capacity is 3,867 megawatts (MW). There are 13 hydropower plants generating 52 per cent of electricity, and four thermal plants accounting for the rest and using coal and lignite from

mines within the country. During the war 56 per cent of the generating capacity was damaged, with a greater percentage rendered unusable when transmission lines were destroyed and fuel was unavailable. Sixty per cent of the former transmission network was badly damaged, as was the distribution system. Repairs of the basic system have been a priority for the Reconstruction programme, which has restored almost all of the generation and transmission capacity.

Like other infrastructure sectors, electricity generation remains separated along ethnic lines. There are three power companies, one in the RS and two in the FBH: respectively, Elektroprivreda Republika Srpska, Elektroprivreda Bosnia and Herzegovina in Sarajevo and Elektroprivreda Hrvatske Zajednice Herceg-Bosne in Mostar.. Each operates in distinct geographical zones as a vertically integrated, publicly owned monopoly. Coordination of activities has improved, and in late 1998 a Joint Power Coordination Centre (JPCC) was set up to coordinate the exchange of electricity between power providers. The World Bank has devised a Sector Policy for the energy sector, including adoption of new sector legislation, the formation of a single transmission company, state-wide regulatory mechanisms and the commitment to unbundle and privatise the individual electricity companies. At the end of 2000, the FBH authorities had agreed to submit the necessary legal amendments to their Parliament, while the RS had not yet authorised this submission at ministerial level.

A large restructuring programme is in preparation, involving the EBRD, the EIB, the World Bank and bilateral donors in the framework of the Stability Pact. The programme is designed to reform the power sector by facilitating private participation in the sector and by introducing competition both among the utilities and from outside the country, in accordance with EU directives on the supply of electricity. The project is a move forward from earlier initiatives which focused on restoring the basis electricity supply. (See *Case study: Power III* below.)

In the past few years the World Bank and other donors have financed reconstruction assistance worth US\$ 196.4 million for the Emergency Electric Power Reconstruction Project. The EBRD participated in this project with € 14 million of its own funds and has administered bilateral grant funds in an amount equivalent to € 10.5 million, followed by a further US\$ 170 million for a Second Electric Power Reconstruction Project. Priorities for these projects include repair of the hydroelectric infrastructure, work on the thermal plants, repair of transmission facilities, and upgrading of coal mining equipment to ensure fuel supplies.

Case study: Power III

Under the Stability Pact's "Quick Start" programme, the Third Electric Power Reconstruction Project (known as Power III), was approved in November 2000, aimed at integration of the power network with European networks. The project will reconnect the power system to the Union for the Coordination of Transmission of Electricity (UCTE), an association of west and east European transmission system operators that promote the reliable operation of electricity networks. It will also include a Supervisory Control and Data Acquisition (SCADA) System component to improve power dispatching and facilitate the operation of the high-voltage network within Bosnia and Herzegovina on an integrated basis. Investments in power distribution will be made to provide electricity to returning refugees and to reconstruct damaged facilities, relieving serious overloading in some areas and enabling reduction in the high levels of technical distribution losses. Investments will also be made at selected hydropower stations to improve safety and plant availability, and at thermal power stations to reduce pollution.

Technical assistance elements will pay for the establishment of an Independent System Operator, a survey of socially vulnerable electricity consumers, commercialisation of the power sector enterprises, and the establishment of regulatory agencies. Led by the World Bank, Power III involves total financing of about US\$ 234 million and is being financed by the World Bank, the EBRD, the EIB and the EC, and bilateral donor countries including the US, Switzerland, Norway, Spain, the UK, and Italy. It will be implemented by the JPCC and the three power utilities jointly.

The EBRD is contributing € 50 million (US\$ 42.6 million), to be used to establish the SCADA monitoring and control system and an Energy Management System which will improve power dispatching and facilitate the operation of the high voltage network within Bosnia and Herzegovina on an integrated basis. These systems will help the country to rejoin the UCTE as a single control area, save fuel through improved generation scheduling, reduce outages and increase sales, reduce costs at sub-stations, and bring in revenue from the sale of surplus communications system capacity.

The EIB is contributing € 60 million (US\$ 51.24 million) to help refurbish the key high voltage transformer substations and switch yards. The World Bank is contributing US\$ 30 million, most of which will be used for reconstruction of 12 main 400 kV transmission lines. The Power III project will be a major step forward for restructuring in the power sector, improving efficiency and standards, as well as providing regional integration.

Transport

Roads and railways continue to be upgraded with support from the international community. Under the Stability Pact's "Quick Start" infrastructure programme, the EIB and bilateral donors are financing the upgrade of the road network through three new road projects.

These initiatives follow on from two emergency transportation reconstruction projects conducted under the post-war Reconstruction Programme, covering rehabilitation of major road routes, priority bridges and road tunnels, equipment for road and railway maintenance, rehabilitation of Sarajevo airport, equipment for urban transport, mine clearing, and technical assistance for all these provisions.

The Japanese government has financed a "Transport Master Plan" to develop domestic roads, railways, inland waterways and air transport with the assistance of the Japanese Agency for International Cooperation. Development of the north-south corridor is a priority under the plan, which was submitted to the State government in November 2000 and due to be finalised in March 2001. It was drawn up in consultation with both Entities separately. It envisages implementation in phases, the last of which would take place in 2020.

The World Bank is funding a project for **Trade and Transport Facilitation in Southeast Europe**, which involves modernisation of customs administration, upgrading of information systems, improvements to border crossing infrastructure and equipment and technical assistance for trade facilitation. This regional programme involves Albania, Bosnia and Herzegovina, Bulgaria, Croatia, and FYR Macedonia. An investment of up to US\$ 140 million is planned for the period to 2003. The main sources of financing will be the World Bank (US\$ 38 million), its soft-loan arm the International Development Agency (US\$ 30 million), the US government (US\$ 9 million), and the EU (US\$ 50 million), with participating countries providing US\$ 18 million. This programme will represent the first regionally linked project in support of the Stability Pact.

Roads and railways

Efforts are now under way to improve connections between the country's 21,700-kilometre **road network** and neighbouring countries. Construction has begun on roads that belong to the Pan-European Transport Corridor network.

In March 2000 the EIB announced a loan of € 60 million for three **road schemes**, a new express by-pass around Sarajevo, a bridge

on the Neretva river at Capljina in the FBH and the rehabilitation of various stretches of road of national and international importance in the RS. Total project cost is estimated at some € 120 million, with contributions expected from the EU's grant aid programmes. The project, given priority as a Stability Pact "Quick Start" initiative, aims to facilitate international traffic and foster exports.

Bosnia and Herzegovina has 1,030 route-kilometres of standard gauge railway network. Before the war it was of a comparatively high standard, of which 75 per cent was electrified. The network is predominantly hilly, and includes 174 tunnels and 339 bridges as well as curves and steep gradients. This kind of topography tends to lead to heavy wear and tear of the infrastructure. The network has two main routes. The first, part of Pan-European Corridor V, runs north-south for 406 kilometres from the border with Croatia at Samac, through Sarajevo, to the Croatian border just north of the Port of Ploče on the Adriatic sea. The second runs 285 kilometres east-west, parallel to Pan-European Corridor X, from the border with Serbia at Zvornik, through Doboj and Banja Luka, to the Croatian border near Novi Grad. There are also several shorter branches and a secondary route through Bihac to Croatia. The total war damage to the railway system is estimated to amount to US\$ 1 billion. Since the Dayton Agreement was signed in November 1995, a considerable amount of reconstruction has taken place but the railway system has been left unable to meet demands for passenger and freight transportation.

The EBRD and the EIB are preparing a railway recovery project to cover priority rehabilitation work on the north-south Corridor V route and the east-west line which runs parallel to Corridor X, in order to foster regional trade and integration. The EBRD would provide financing of € 20 million for purchase of track maintenance machinery and rehabilitation of safety and signalling installations. Co-financing of € 30 million from the EIB would be used mostly for track renewal. The project would encourage the merger between ZBH (the railway operating in Bosnian areas) and ZHB (the railway operating in Croatian areas) and would require the railway companies to establish business planning capabilities and business plans based on realistic forecasts. The project is likely to be put before the EBRD's Board for approval in May 2001. The EU is also conducting a project to repair and install railway signal and telecommunications systems.

Airports

There are four airports serving commercial traffic, at Sarajevo, Tuzla, Banja Luka and Mostar. Sarajevo airport has been undergoing reconstruction since being badly damaged in the war, and has benefited from a repaved runway, a reconstructed control tower, and a renovated passenger terminal, all financed by the

international community. The airport serves 10 carriers operating scheduled flights, with direct services to a number of major European cities. The EC is financing reconstruction of the civilian airport at Mostar with commitments totalling € 4.1 million. The airport will have a new control tower and various administrative facilities as well as an emergency power generator. Tuzla airport reopened in June 1999 with regular flights to and from Frankfurt.

Sea and river ports

Bosnia and Herzegovina's main access to the sea is through the Croatian port of Ploče. In 1999 an agreement was signed which guarantees Bosnia and Herzegovina access to Ploče port and customs-free trans-shipment. This has led to a significant increase in transit. Ploče has become an important partner for Aluminij Mostar in its alumina import and aluminium export operations. Another major partner for Ploče port is the Zenica steel works. The entire port is a customs free zone under Croatian law, and goods bound for Bosnia and Herzegovina pass through it without paying Croatian customs.

A modern terminal for liquid cargo has been constructed at Ploče port at a cost of about HRK 40 million (US\$ 4.5 million), with the support of international companies delivering fuel for Bosnia and Herzegovina. It became operational in late November 2000 and will handle some 220,000 tonnes of liquid cargo each year, greatly increasing the port's annual turnover. Fuel was formerly transported via the Slovenian port of Koper, then by road, so the new terminal will reduce transport costs and provide a more practical alternative route.

Bosnia and Herzegovina has another important port at Brčko (RS) on the river Sava. In March 2000 Brčko was proclaimed a district under the jurisdiction of Bosnia and Herzegovina's joint institutions, paving the way for a restoration of the port's full services. The Sava River gives Bosnia and Herzegovina access to the Danube river network.

Tourism

The war did nothing to encourage tourism, which suffered badly. Many historic buildings were irreparably destroyed. However, there are now signs of a revival, which will be further boosted by the opening up of Yugoslavia. Bosnia and Herzegovina has plenty of spectacular sites, such as the mediaeval city of Mostar, whose famous Ottoman-era Old Bridge (built in 1566) is being reconstructed. The World Bank is providing credit of US\$ 4 million for the project, which began in 2000 and is due to be completed in 2002. The old town of Mostar is also to be rebuilt. These projects are part of a US\$ 15.5 million international cultural heritage package

funded by the World Bank, UNESCO, the Aga Khan Trust for Culture and bilateral donors including Italy, the Netherlands, Slovenia and Austria in cooperation with the City of Mostar.

Bosnia and Herzegovina is a very beautiful country, with dramatic mountains and fascinating Ottoman architecture (especially in Sarajevo). The country offers skiing, hunting, and popular white-water rafting expeditions. Hotels and ski resorts have been gradually undergoing renovation in preparation for the recovery of tourism. Even the war offers a tourist opportunity, with organised visits to the combat zones. Needless to say, there is still much work to be done to improve the infrastructure, not least the removal of landmines. So far, the tourists are mainly intrepid backpackers touring Europe, or day visitors crossing the border from the Croatian coast.

Slovenia's Terme Catež is considering a joint venture with the Sarajevo Canton to establish a health resort complex at Ilidža.

Water

During the war, the country's water and waste water management systems suffered extensive damage, which was compounded by the division of the country and the massive population movements that followed. The water supply has now been almost entirely restored, thanks to international funding and the efforts of local institutions. However, the quality of services varies greatly, and most water management companies face severe financial difficulties and an inability to collect cash payments for water, much of which is paid for through barter. Sewage treatment is highly unsatisfactory, with few proper disposal systems in operation.

The World Bank is conducting a water supply and sanitation project in Mostar, to reunite the water and sewerage utility (divided since the war) under the management of a private sector operator, who will initiate policy reforms and increase the operational efficiency of the combined systems. It will also implement an investment of US\$ 12 million to install new water supply equipment, replace leaking pipes, construct pump stations, rehabilitate existing resources and buy computers and other equipment. It will also finance rehabilitation of the sewers, replace the pipes and supply sewer maintenance equipment. EC-Phare is financing a project for € 25 million to rehabilitate the water supply distribution and waste water systems in nine municipalities, to improve the availability of clean drinking water, increase the efficiency of waste water treatment, promote ecologically sustainable, safe management and use of water resources and strengthen the relevant institutions.



Financial sector

The year 2000 marked the start of major reforms of the banking and payments systems. At present the banking sector hardly fulfils its function, but inevitable progress with consolidation, privatisation and competition will streamline it into a working system. A large step forward was the replacement of the Payment Bureaux with an inter-bank clearing system. Foreign participation is increasing, boosting standards and services. The acceleration of privatisation, which has been much delayed, will be crucial in 2001.

Now that it is successfully performing its main role in acting as a currency board for the Konvertibilna Marka (KM, which is pegged to the Deutschmark), the Central Bank of Bosnia and Herzegovina (CBBiH) is focusing on reform. It has already achieved its task of reforming the payments system and establishing an independent clearing house (see below). It plans to cut fees for its financial services to commercial banks and other clients, which should help these institutions to cut their own rates. It is also planning to set up a centralised database of foreign direct investments.

According to the CBBiH, by November 2000, there were 50 commercial banks operating in Bosnia and Herzegovina (32 in the Federation and 18 in RS). Despite the large number of banks, the sector is relatively concentrated with most assets in a small number of state-owned banks. In the FBH, 11 majority state-owned banks control around three-quarters of total banking assets, while four of the state-owned banks in the RS control around two-thirds of all assets. Most state-owned banks have inherited bad portfolios with non-performing and unrecoverable assets. Many banks are too small and undercapitalised to survive over the medium term and further consolidation in the sector is inevitable.

Banking legislation is in place and is being strictly implemented in the run-up to privatisation. The minimum capital requirement was raised in January 2001 from KM 5 million to KM 7.5 million and will be gradually increased to KM 15 million in 2002. There is strong pressure on the smaller banks to consolidate. Other factors driving consolidation include the effects of new foreign competition, which is changing interest rate margins, with loan rates for 3-5-year loans falling from 15 to 20 per cent or higher to around 12 or 13 per cent. The introduction from the start of 2001 of a new small depositor's insurance scheme, covering deposits of up to KM 5,000, will also contribute to the disappearance of banks that fail to meet the criteria for participation in the scheme. To qualify, banks must have equity of over KM 7.5 million (US\$ 3.5 million). These moves should also help to restore public confidence in the banking sector, which is weak, leading to a low deposit base and no capacity for credit. Few banks are expected to survive. The existing private

banks, set up during or since the war, are mostly small and undercapitalised, taking very few deposits, doing little lending and trying to generate income on a fee basis.

Until recently, Bosnian banks could only operate in their own Entity. A new Entity-level banking law now allows banks in one Entity to open branches in the other. The Micro-Enterprise Bank (MEB) was the first bank to open a cross-Entity branch in Banja Luka (RS) in November 2000. On 16 March 2001 FBH-based Market Banka (now renamed Raiffeisen Bank Bosnia – see *Case study* below) opened its first branch in Banja Luka, and several banks from the RS are in the process of establishing a presence in the FBH.

Banking privatisation

Bank privatisation is proceeding very slowly, with delays to the programme that was supposed to take place by the end of 2000. Seventeen banks (10 in the FBH, seven in RS) are mainly or entirely state-owned and the privatisation programme for these banks is well behind schedule, mainly because of delays in submitting their opening balance sheets, the first step in the process.

In the FBH, eight banks are due to be privatised by the end of June 2001. These are Postanska Banka, Sipad Banka and Union Banka, as well as the five banks that make up the Privredna Banka group: Central Profit Banka, Gospodarska Banka Mostar, Privredna Banka, Travnicka Banka and Una Banka. Central Profit Banka is the most attractive prospect, and foreign interest is expected in Privredna Banka and Union Banka. The rest are weak and only likely to attract domestic investors, while the fate of the troubled Gospodarska Banka Mostar is uncertain. A tender was opened for the sale of 51 per cent of the Federal Investment Bank (FIB) in September 2000. The FIB has the largest credit portfolio in the country, assets of KM 120 million (US\$ 56.8 million) and in 1999 achieved tax-exempt profit of KM 3.5 million. Established in 1997 to foster economic growth, it is free of pre-war debt.

In the RS, only one out of five bank privatisation tenders approved had been successfully completed by the end of the year. This was the sale of 51 per cent of Agroprom Bank, which raised just over DM 3.3 million, with the state retaining

a 15 per cent share. In October the RS government approved a privatisation plan for eight banks. The tender for the largest RS bank, Kristal Banka, was reissued in October 2000.

New deadlines for bank privatisation by the middle of 2001 have now been set in both Entities. Banks that fail to meet the deadline will be liquidated, even if they are solvent.

USAID bank development and training programme

USAID has selected three local banks to receive a total of DM 18 million over two years through its bank development and training programme, which is open only to private banks that show promise. The chosen banks are Gospodarska Banka and UPI Banka, both based in Sarajevo, and Hrvatska Postanska Banka, based in Mostar. Through the programme, bank personnel will gain access to formal training in strategic planning, internal auditing, accounting, bank operations, information technology and liquidity management. USAID is also launching a programme to provide mortgage loans to citizens of Bosnia and Herzegovina.

Foreign participation in the banking sector

Foreign participation is increasing rapidly, and is expected to oblige local banks to raise their standards in the face of competition. The privatisation process is expected to bring in more strategic foreign players.

In August 2000 privately-owned Market Banka was taken over by Raiffeisen Zentralbank (Austria). Previously the most profitable local bank, Market Banka also has EBRD equity participation (see *Case study* below). Raiffeisen is said to be considering acquiring a second Bosnian bank. Volksbank (Austria) became the first EU bank to establish a presence in Bosnia and Herzegovina, when it opened its subsidiary, Volksbank Bosnia and Herzegovina, in July 2000 with an initial capital base of DM 10 million (US\$ 4.9 million). This was a positive event, creating competition and encouraging the adoption of international banking practice throughout the sector. Volksbank hopes to build a base of corporate clients that trade with western partners. For now it is keeping its retail operations at a minimum, but that is expected to change in the future. Volksbank was rapidly followed by the opening of branches of Oesterreichische Volksbanken (Austria) in the FBH, and the Lithuanian-owned Balkan Investment Bank, which was the first foreign bank to open a fully-owned subsidiary in the RS.

Zagrebacka Banka (Croatia) has taken a controlling share in Hrvatska Banka Mostar, in which the EBRD also holds a share. Hrvatska Banka Mostar is now called Zagrebacka Banka BH.

Zagrebacka Banka also bought a majority share in Universal Banka in January 2001 for DM 40 million. Universal Banka is one of the leading banks in the FBH, with a sizeable market share, particularly in corporate banking where it has about 2,000 customers. Established in 1993, it has a balance of some DM 130 million and, besides its head office in Sarajevo, has seven branches in the FBH. Zagrebacka Banka and Universal Banka jointly took over the assets and liabilities of Komercijalna Banka Tuzla, which would take the group into the RS. Bank Domzale (Slovenia) has acquired a 51 per cent stake in Commercial Bank Sahinpasic, renamed Commercebank.

Turkey's state-owned Ziraat Bank Bosnia has been operating since 1997, but focusing on trade finance and money transfers rather than looking for local deposits. In November 2000 the Islamic Development Bank, Dubai Islamic Bank and Abu Dhabi Islamic Bank joined forces to launch a new foreign-owned financial institution, the Bosnia International Bank, which is registered with initial capital of KM 50 million (US\$ 21.9 million). In December, Hypo Alpe Adria (Austria) took a 20 per cent stake in Auro Banka, based in Mostar, through its Croatian holding, Slavenska Banka, and is rumoured to be planning to move to a majority stake by the end of 2001.

Closure of the payments bureaux

The Payments Bureaux were a Yugoslav remnant that prevented banks from offering payment services and provided opportunities for bureaucratic interference and control. Until this year, the payments bureaux exercised a monopoly over domestic financial transactions, were seen as a source of corruption and were a major deterrent for investors. Under an agreement with the IMF, their role has been gradually phased out, ending in their liquidation at the end of 2000, and their replacement with a new inter-bank clearing system which went into operation on 5 January 2001. At the end of 2000, the Bureaux' payments functions were transferred to commercial banks. Banking agencies in both Entities have issued licences to existing commercial banks for this purpose. By January 2001, some 37 banks had been granted licences for payments functions. The CBBiH has introduced a real-time gross settlement system as a means of settling accounts among commercial banks. An international tender for this system was issued in April 2000 and won by Logica (UK), who set up the new clearing system with the assistance of Helcom, a Slovenian computer company.

While initially the CBBiH will own and control the clearing system, gradually commercial banks will be able to become joint owners.

Case study: Raiffeisen Bank Bosnia and Herzegovina (formerly Market Banka)

Since its takeover in August 2000 by Austria's Raiffeisen Zentralbank (RZB), from October Market Banka has a new name, Raiffeisen Bank Bosnia and Herzegovina. The bank already has six branches in the FBH, and in February 2001 the bank obtained approval to set up a branch in Banja Luka in the RS, which was inaugurated on 16 March, with plans for a second in Brčko. Market Banka, based in Sarajevo, was established during the war in 1992 by local companies operating in the area. It employed 50 staff and had branches in Gorazde, Visoko and Mostar. In late 1997 the EBRD made an equity investment of DM 2 million in Market Banka's share capital, to help strengthen its capital base, supported by a technical assistance package funded by EU-Phare and designed to provide guidance and institution building. It was also intended to help the bank to attract other shareholders and additional funding sources. The EBRD had identified Market Banka as a well-managed bank, run by dynamic and enterprising young people, with the potential to develop and provide support for the emerging private sector, to become a natural contact for foreign banking partners, and above all, set and demonstrate high standards for the Bosnia and Herzegovina financial sector. A precondition of the investment was a twinning arrangement with a foreign partner to conduct the technical assistance programme over a 24-month period. The Bank of Ireland was selected for this role.

By October 1999 Market Banka had attracted additional capital and its equity had increased by more than 600 per cent compared with the 1996 share capital. New investors included the Open Society Institute, a foundation set up by financier George Soros, and Futura Investment (which invested at the same time as the EBRD). Through representation on Market Banka's board, the EBRD had helped to introduce a code of conduct for the Board of Directors and had implemented a Policy Statement. Through the twinning programme improvements were made to the bank's credit operations with the creation of credit risk management personnel and staff to work out problem loans. The organisational structure was also strengthened by introducing procedure and policy manuals for all areas of finance to ensure a full range of accounting controls.

By 2000, Market Banka had developed successfully as one of the country's leading banks, a front runner in corporate transparency with strong credibility, high efficiency and an expanding customer base. Its potential was recognised by RZB, which was keen to add it to its extensive central and east European network. In July RZB purchased about 90 per cent of Market Banka, with the aim of acquiring 100 per cent. RZB praised Market Banka for its good management and well-trained staff, and is investing DM 8 million over its first year of ownership to expand the bank. New products

and services are being introduced, and RZB's international network is allowing the bank – and the country – to be connected to world markets. As the only bank to offer its services in both Entities, it offers extra benefit for the country's unity. RZB also plans to make the bank a hub for further expansion in south-eastern Europe, which will help Bosnia and Herzegovina's regional connections as well. Thus, through its excellent performance, the country's best and most profitable bank has attracted an international partner and will contribute to national, regional and international integration.

Financing for SMEs

Access to capital for SMEs remains very limited. Slow progress in both Entities in restoring confidence to the banking system has meant that virtually the only sources of finance available to SMEs are from IFI and bilateral donor programmes. However, these programmes are insufficient to meet the demands of the sector, and SMEs face very high real interest rates on commercial bank loans. The recent entry of foreign strategic investors in the banking sector is expected to provide competitive pressure, which may improve borrowing terms for SMEs. Most programme funding is made available to SMEs outside the banking system, using a network of NGOs. The majority of these are aimed at providing highly subsidised loans to SMEs rather than building sound banking institutions that can sustain SME lending over the medium term. A more commercially oriented approach to programme funding of SMEs could enhance the sustainability of these important efforts. Some examples of existing SME financing programmes follow.

The EBRD has established a DM 30 million **SME credit line** to be on-lent by local banks to SMEs. Four local banks – Zagrebacka Banka Bosnia (formerly Hrvatska Banka), Market Banka, UPI Banka and Kristal Banka – have been selected as intermediaries. The EBRD is providing DM 20 million on its own account, with the remaining DM 10 million financed by the Italian government, which is also providing a DM 3.1 million grant to fund a technical assistance programme for the participating banks. This will give SMEs access to much needed long-term financing. The funding will be lent not only to private enterprises but also those undergoing privatisation. It will also strengthen the lending capacities of the banks and promote good corporate governance in the banking sector. Of the banks selected, Zagrebacka Banka is receiving DM 10 million and UPI Banka and Kristal Banka DM 5 million each. Market Banka received an original DM 5 million, which is to be increased by a further DM 10 million.

In cooperation with the IFC, the EBRD has also established a **Micro-Enterprise Bank (MEB)**, first set up in November 1997. Other contributors to the bank's DM 5.25 million capital were the Netherlands Development Finance Company, IPC – a German firm specialising in micro and small enterprise finance, and BH Banka, a local bank. The three main objectives of MEB are to provide financing to micro and small enterprises with a credit requirement typically between DM 2,000 and DM 50,000; to develop sound micro and small lending techniques, to show local banks that such lending can become a profitable activity; and to create a sustainable financial intermediary that in the long run will be managed and owned exclusively by local citizens. MEB's track record is impressive. By the end of January 2001 it had made 86,829 loans to clients resulting in a total disbursement of US\$ 30,479,916. Disbursements by sector were: trade – 65 per cent, services – 21 per cent, and production – 14 per cent. The average loan size was US\$ 4,463. MEB has opened branches in Sarajevo, Ilidza, Bihać, Mostar and Tuzla and was the first bank registered in the FBH to start operations in the RS when it opened a branch in Banja Luka.

USAID's Business Development Programme (BDP), worth a total of US\$ 278 million, was designed to provide quick-disbursing loans to local SMEs, as well as consultancy services. All loans are processed through local banks, adding to their capacity to operate successfully within an open market. USAID loan recipients account for 50 per cent of all post-war exports. The loans have the further benefit of creating new jobs by allowing small businesses to expand. Typical loan recipients are in manufacturing (furniture, metal), forestry (logging, sawmills), agribusiness and food (milk products, fruit processing, bread) and construction (building materials, cement). Loan appraisal is managed on site by experienced US consultants. A second team provides consultancy services, helping loan applicants to draw up realistic business plans. Further follow-up assistance helps to improve financial management and marketing skills. The BDP's activities initially concentrated on the US SFOR sector and Sarajevo, but have expanded to cover central Bosnia and Herzegovina, the RS and the Brčko district.

Kreditanstalt für Wiederaufbau, the German development agency, has been managing a SME credit line, funded by the German, Austrian and Swiss governments as well as EC grants. It targets small enterprises throughout the country and operates through seven banks. DM 1 million is dedicated to start-ups, which have particular difficulty in accessing credit.

The World Bank's **Local Initiatives Project** was set up in 1996 to provide emergency post-war assistance to the economically disadvantaged for start-ups or business development. It includes a micro-credit programme worth a total of US\$ 15 million, which

provides micro-credits through local NGOs. The project also aims to help develop independent, financially viable micro-finance institutions through technical assistance and training. Other donors were the Netherlands, Japan, Italy, Switzerland, Austria and the UNHCR. The World Bank is also contributing to SME development through its **Private Sector Development** project, which includes a US\$ 10 million credit line for SMEs, administered by local banks.

The **Southeast Europe Enterprise Development (SEED)** is an IFC initiative designed to support the development of SMEs in south-eastern Europe (Albania, Bosnia and Herzegovina, FYR Macedonia and Kosovo). By December 2000 funding commitments totalled US\$ 20 million, with a further US\$ 13 million to be secured over the five-year life of the programme. The IFC is providing funding and also the management team to implement the SEED. Main aims include outreach to regional investment funds for potential pipeline development, investment preparation and post-financing services, creation of business centres to support Internet-based learning among SMEs and their support institutions, development of advocacy groups for SMEs, local training and technical assistance towards developing a local consultancy capacity for SMEs, and development of enterprise zones, and leverage of undisbursed international funds towards SME development. In Bosnia and Herzegovina the SEED plans to support the development of new institutions and is examining the possibility of supplementing a USAID-funded Bank Training and Development programme by adding a component to build up the capacity of local banks to lend to SMEs. The SEED is also considering funding a European member of the Securities Commission to help introduce best practice and contribute positively to the development of the regulatory and operating environment for newly privatised SMEs. The SEED will also work to develop a post-privatisation pipeline of companies to receive basic skills development training and assistance in accessing financing.



EBRD activities in Bosnia and Herzegovina

As at 31 December 2000, the European Bank for Reconstruction and Development (EBRD) had approved 15 projects in Bosnia and Herzegovina, totalling € 142.57 million. The portfolio consists of 11 investments in the private sector totalling € 26.07 million and four in the public sector totalling € 116.5 million.

Overview of EBRD activities and key objectives

Bosnia and Herzegovina became a shareholder and a country of operations of the EBRD in April 1996. The initial focus of the Bank's operations was on emergency infrastructure reconstruction (Sarajevo International Airport; road and bridge rehabilitation; upgrading of the air navigation system; power system and telecommunications reconstruction). The Bank was the first financial institution to lend on commercial terms and conditions in the public sector. In addition to its financing role, the Bank contributed to the consolidation of the peace process through:

- support at an early stage to integrative infrastructure projects covering the whole territory of the country, thus contributing to the implementation of Annex 9 of the General Framework Agreement for Peace in Bosnia and Herzegovina (GFA);
- institutional development work such as the regulatory framework of the telecommunications sector; and
- devising legal documentation reflecting the complex constitutional structure set up by the GFA.

During 1997, the Bank began to shift its focus from emergency infrastructure rehabilitation towards its core mandate, the promotion and development of the private sector. The Bank pioneered equity investments in Bosnia and Herzegovina (directly through equity participation in private banks, such as Zagrebacka Banka BiH (at that time Hrvatska Banka) and Market Banka (now Raiffeisen Bank) or indirectly through the establishment of the Horizonte Enterprise Fund). Market Banka has also become the first bank in Bosnia and Herzegovina to benefit from the EBRD's Regional Trade Facilitation Programme.

These projects, together with the introduction of micro lending on commercial terms (the Micro-Enterprise Bank) have enabled the Bank to establish itself as a major actor in the strengthening of the country's financial sector. In addition, the Bank, together with the IFC, provided the first term loan to a majority privately-owned local company (Sarajevo Brewery).

The EBRD has invested significant financial and staff resources in preparing and implementing its operational programme in the country. The Resident Office in Bosnia and Herzegovina opened in July 1996. It focuses on policy and operational dialogue, including project-related policy issues, with the local authorities as well as on project origination and project monitoring.

Main objectives

The EBRD promotes private sector activity, corporate restructuring and sound corporate governance. In fulfilling its role as a catalyst of change, the Bank encourages co-financing and foreign direct investment, helps to mobilise domestic capital, and provides technical cooperation in relevant areas. It works in close cooperation with the IFIs and other international and national organisations. In all of its activities, the Bank promotes environmentally sound and sustainable development. The Bank's Turn Around Management (TAM) programme is used to provide pre- and post-investment support in transactions with local companies.

The EBRD's strategy for Bosnia and Herzegovina

During 2001-02, the EBRD will focus on the following operational objectives, reflecting Bosnia and Herzegovina's progress in transition and the remaining sectoral challenges:

The Bank will extend its participation in the re-launched tender privatisation process and its support to new or existing private companies through:

- provision of pre-privatisation and post-privatisation finance and early contacts with potential foreign investors interested in acquisitions in the country with the aim of supporting a number of the first significant privatisations in the cement, light industry and automotive components sectors;
- selective consideration of financing for local companies with a clear capacity to be successful in a regional market;
- promoting access to longer maturity debt financing for high potential private companies, including through smaller size debt transactions (€ 1-4 million);
- support for cross-border investment from the advanced transition countries of former Yugoslavia (e.g. Slovenia and Croatia); and
- continued close cooperation with other IFIs through participation in the International Advisory Group on Privatisation (IAGP).

In the light of the high profile of EBRD involvement in the banking sector and the confirmed resolve of the Entity governments to promote sector restructuring, **the Bank's financial sector activities will increasingly focus on bank privatisation and consolidation, strengthening well established**

SME finance mechanisms and the diversification of financial products. The principal objectives in this area will be:

- supporting the privatisation of selected state-owned banks, especially in the RS;
- supporting the consolidation of local banks through mergers/acquisitions;
- introducing and/or developing further financial products such as trade facilitation, leasing and retail mortgage employing the EBRD's existing network of client banks; and
- supporting SMEs through the replenishment of the existing credit line and a new venture capital fund targeting privatising SMEs and also providing technical assistance.

As the emphasis shifts from emergency repairs towards sector development, the Bank's objective will be to **finance infrastructure projects which will support state-wide operational or regulatory institutions, and/or create regional linkages with neighbouring countries.** Specifically the Bank will:

- promote the privatisation of the three ethnically oriented telecommunication operators, potentially through loans or direct investments with a strategic investor;
- support transport infrastructure rehabilitation and development through public-sector loans with increased institution building and sector policy components;
- promote regional integration in the fields of transport and power through the financing of the rehabilitation of the two European railway corridors and the establishment of a joint electric power transmission company; and
- explore the possibility of providing sub-sovereign financing to local municipalities or utilities for water supply, district heating and waste treatment or other municipal services in view of the strong decentralisation of revenue collection in the country.

The Bank will continue an active policy dialogue with the State and Entity governments in Bosnia and Herzegovina and with the international community (IFIs, Office of the High Representative, major donors) as an advocate for economic and commercial incentives for greater integration between the Entities and among the countries of the region. Particular emphasis will be placed on:

- strict adherence to policies and practices which discourage corruption;
- implementation of the Telecommunications Sector Policy and the establishment of an effective regulatory framework fostering competition throughout the State;

- creating an environment conducive to SME development and foreign direct investment building upon the results of the recent FIAS study and the Bank's field experience; and
- strengthening financial sector regulation and the protection of the rights of creditors and minority shareholders.

Close co-ordination with the implementing agencies and donors associated with the Stability Pact for South Eastern Europe will continue with special emphasis on private sector initiatives where the Bank has a lead coordinating role.

Approved projects as at 31 December 2000

Emergency transport reconstruction

The EBRD signed its first loan agreement with Bosnia and Herzegovina on 5 December 1996. Within the framework of the emergency transport reconstruction project, the Bank provided a loan of US\$ 32.7 million. This has been used to finance the first stage of the reconstruction of Sarajevo International Airport, the upgrading of the air navigation system as well as a road and bridge repair programme.

Emergency power system reconstruction

Almost all power generating stations, both hydro and thermal have suffered damage either caused directly by the war or by the impossibility of maintaining the facilities in proper operating conditions. According to estimates, at the end of the war the transmission line network and control systems were 50 to 80 per cent damaged, and about 50 per cent of the distribution network was damaged or destroyed. An EBRD loan of € 14.1 million was signed in November 1997 to improve electricity transmission and distribution lines across the whole country.

Electric Power Reconstruction Project

In November 2000 the EBRD made a sovereign loan of € 50 million to Bosnia and Herzegovina to help ensure a reliable supply of electricity throughout the country by financing projects to improve the integration of the network. The investment will be used to establish the SCADA monitoring and control system and Energy Management System which will improve power dispatching and facilitate the operation of high voltage networks within the country on an integrated basis. These systems will help the country to rejoin the Union for the Coordination of Transmission of Electricity (UCTE), an association of west and east European transmission system operators promoting the reliable operation of electricity networks.

Emergency telecommunications reconstruction

The telecommunications sector suffered extensive war damage. Most of the backbone transmission network was destroyed, as were most transmission and switching equipment, buildings, towers and overhead cables. As part of its coordinating role in this sector, the EBRD has sought to match potential donor funds to project elements as well as to fund a significant proportion of reconstruction from its own funds.

The immediate priorities defined by the EBRD and the local authorities are the following:

- restoration of access to the telephone service throughout the country;
- re-establishment of telecommunications links between all municipalities; and
- increase in international capacity.

The EBRD loan was € 18.1 million, while another € 25.76 million has been secured from other donor sources. The loan was signed in June 1998.

Horizonte Enterprise Fund

The Horizonte Enterprise Fund, managed by Horizonte Venture Management GmbH Austria, is a closed-end investment fund with a ten-year term. It was launched in January 1998 and has an initial capitalisation of US\$ 18 million. The Fund's objective is to achieve long-term capital growth and accumulate dividend income by making direct equity and equity-related investments in a portfolio of small and medium-sized private or privatising companies in Bosnia and Herzegovina.

The Fund contributes equity capital by replicating the investment approach that the Horizonte Slovenia Fund has been successfully following. This will include a special effort to tap the potential for joint ventures. The Fund would eventually achieve long-term capital gains by monitoring the development of its portfolio companies through various growth stages and by adding value in financial management, sales, marketing and organisational development. In January 1998 the EBRD signed an equity investment of US\$ 5 million in the Fund for a term of 10 years.

Equity investment in private banks

On the basis of an analysis of local financial institutions, in 1996-97 the EBRD aimed to take an equity participation in selected private banks in order to strengthen them and to enable them to provide more effective financial intermediation and meet the needs of the enterprise sector. In addition

to equity participation, funds were provided for the substantial and longer-term technical assistance programme for these banks. The EBRD has invested € 1 million so far in both Hrvatska Banka d.d. (Mostar) and Market Banka d.d. (Sarajevo).

Micro-Enterprise Bank

The Micro-Enterprise Bank (MEB) was set up to provide financing for private micro and small enterprises in Bosnia and Herzegovina. By using sound lending techniques, the bank will demonstrate to other local banks that micro-lending operations can be developed into a profitable activity. MEB had an initial capital of DM 3.5 million, which has been increased to DM 5.75 million in total equity.

The founding shareholders are the EBRD, which has provided an equity investment of DM 1.5 million (€ 0.5 million), the IFC, International Micro Investition (Germany), KfW (Germany) and FMO (Netherlands). MEB also benefits from an € 11 million loan provided by the European Commission and from a NOK 2.7 million grant provided by the government of Norway for on-lending.

Having opened in November 1997, MEB extends micro and small credits to private enterprises with up to 50 employees. The targeted industry sectors include manufacturing, services and trade. Loans are denominated in DM and typically range between DM 2,000 and DM 50,000, with a targeted average loan size of DM 15,000 to ensure portfolio diversity. MEB lends on commercial terms, and interest rates are set to recover the full cost of funding plus operating costs and a margin for profit and provisions. The maturity of the loans is from one to 36 months.

By the end of January 2001, MEB had granted 6,829 loans worth US\$ 30.5 million. The over-30-days arrears rate on the loan portfolio stands at 0.6 per cent, demonstrating the high quality of the bank's lending activities. MEB has opened branches in Sarajevo, Ilidza, Bihac, Mostar and Tuzla, and was the first bank registered in the FBH to start operations in the RS when it opened a branch in Banja Luka in November.

Sarajevo Brewery

In November 1997 the EBRD provided a loan of € 3.0 million for the modernisation of Sarajevska Pivara, the largest brewery in Bosnia and Herzegovina. The project was co-financed with the IFC and has allowed the company to expand its operations into soft drinks.

Tuzla Brewery

In September 1999 the EBRD approved a loan of DM 12 million for the modernisation of the existing production facility of the Pivara Tuzla, a privately owned brewery in north-east Bosnia and Herzegovina, to improve the quality of the company's products and to develop its sales regionally.

Framework for SME financing

In December 1999 the EBRD approved a credit line totalling € 15 million, which will provide SMEs with access to medium to long-term financing on commercial terms. Three local banks (Hrvatska Banka, Market Banka and UPI Banka) have been selected so far as intermediaries. The framework will support not only private enterprises but also the privatisation of state-controlled businesses. Two more banks are expected to receive financing under the framework in 2001.

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Signed projects as at 31 December 2000 (in € million), exchange rates as at 31 December 2000

Operation name	Sector	Total cost	EBRD signed
Emergency Transport Reconstruction Project	Transport	103.0	34.4
Telecommunication Emergency Reconstruction Project	Telecom	45.7	18.1
Emergency Power System Reconstruction Project	Power	164.5	14.0
Electric Power Reconstruction Project	Power	244.0	50.0
Trade Facilitation Programme*: UPI Banka, Market Banka and Zagrebacka Banka	Finance	0	0.2
Zagrebacka Banka (Hrvatska Banka equity)	Finance	1.0	1.0
Micro-Enterprise Bank equity	Finance	6.8	0.76
Raiffeisen (Market Banka equity)	Finance	1.0	1.0
SME credit line -Zagrebacka Banka	Finance	5.0	3.3
SME credit line -UPI Banka	Finance	2.5	1.65
SME credit line - Raiffeisen	Finance	2.5	1.65
Micro-Enterprise Bank loan	Finance	2.64	2.64
Horizonte Enterprise Fund	Finance	15.5	4.65
Pivara Tuzla	Agribusiness	9.35	6.13
Sarajevska Pivara	Agribusiness	11.7	3.09
Total		615.19	142.57

* Only utilised amounts

Notes